Convertible Bonds: Opportunities in a More “Bond-Like” Asset Class

Here’s why convertibles may represent an attractive approach for investors who have previously focused on traditional bonds

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Figure 1. Average Forward Returns for Convertible Bonds After Drawdowns Similar to Today’s Have Been Favorable

Source: ICE BofA US Convertible Index and Lord Abbett. Data as of 5/31/2022. A drawdown is a peak-to-trough decline during a specific period for an investment, trading account, or fund. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. Past performance is not a reliable indicator or guarantee of future results.
The ongoing debates around the probability of a U.S. recession, the depth and duration of any slowdown to come, and what outcomes might already be “priced in” across assets have all been headwinds to risk markets. Meanwhile, a market-unfriendly U.S. inflation report on June 10 further added rationale for a more hawkish U.S. Federal Reserve (Fed).

Investor conviction remains low, and all the factors mentioned above have manifested themselves in choppy price action across credit and equities over the past several weeks—just as we head into the summer, a season of historically lower liquidity in the markets.

As a ‘hybrid’ asset class, the convertible bond market serves as a meeting place for addressing the range of these investor concerns across the corporate capital structure. In this Market View, we revisit the case for the convertible bond asset class, in the context of current market conditions.

The Current Drawdown Ranks Among the Largest of the Last 35 years…

Risk assets of all stripes have been under pressure for much of the year as the Fed looks to rein in inflation by tightening financial conditions. In Figure 1 on the first page, we put the current drawdown in the convertible bond market through the end of May into longer-term perspective. Specifically, the current move lower that started in late 2021 has resulted in the fourth-largest drawdown over the studied period dating back to 1987. Without taking a high-conviction view on the timing, shape, and pace of any rebound to come, we can simply note that the average 12-month forward returns after similar episodes of large drawdowns have been quite favorable, even if an investor was late to catch the initial turn higher. While the year-to-date return of the convertible index is roughly in line with the broad S&P 500® Index, the asset class has more exposure to small and mid-cap growth companies, and so historically has been more correlated with the Russell Midcap® Growth index. The Bloomberg U.S. Convertibles Index has provided the downside protection versus its underlying equity exposure, as it typically has, with a return of −16.9% versus the 28.9% decline of the closely related Russell Midcap® Growth Index.

…and May Have Shaped Today’s “Bond-Like” Asset Class

One of the main defensive draws of the convertible bond market historically has been the rising “bond-like” nature of the security that results from declining sensitivity to the underlying equity—should the stock price move further away from the conversion price of the bond. This varying sensitivity of a convertible bond’s price to the underlying equity is known as the bond’s delta. While convertible securities with a high delta are considered “equity-sensitive,” market participants generally consider a convertible bond with a delta below 0.40 to be “bond-like” and thought of as more of a “yield instrument.” In Figure 2, we note that the percentage of the ICE BofA U.S. Convertible Bond Index that fits this characterization recently topped 50%, superseding the breadth of this “yield-instrument” classification seen during the worst of the March 2020 dislocation.

This resulting nature of the convertible bond market today makes comparisons to the traditional credit markets much more applicable, in our view. We believe the bond-like character of the opportunity today can appeal to traditional credit investors who may be searching for any positive convexity to come, beyond what could be derived from traditional credit instruments. In traditional credit, a further rise in benchmark yields would provide a headwind to prospective total returns, even should credit conditions ease and result in spread tightening. And related to our discussion around forward returns post large drawdowns, our prior work referenced above has shown that forward returns are positively correlated with lower starting points of broad market delta that result from a market decline. Further, today the asset class has less equity sensitivity going forward given the current delta, a reality that may appeal to those investors concerned about the potential for a further pullback in equities from here.
Comparing Convertibles to Traditional Credit

At their core, convertible bonds can simply be considered a package of a corporate bond with a call option on the underlying equity of the issuer. However, with the move lower in the broader equity market, the value of the call option (which may have fallen “out of the money”) in many convertible bonds has fallen as a proportion of the overall value of the theoretical price of the bond. We can calculate an implied credit spread of the bond based on certain volatility assumptions for the call option, as well as the maturity and current price of the convertible bond. Courtesy of Barclays, in Figure 3 on the next page, we show the implied option-adjusted-spread of the convertible bond market versus both the ‘B’- and ‘BB’-rated segments of the U.S. high yield market.

While certainly not showing the same spread gain out of high yield we saw in early 2020, the pickup remains attractive, in our view. We have additional comfort in knowing that the default rate in the convertible bond market has generally been at or below that of the U.S. high yield market. Over the period from Q4 2017 through Q1 2022, the trailing 12-month (TTM) default rate in the convertible bond market has averaged 2.45%, versus 3.79% for the U.S. high yield market, based on ICE BofA index data.
And we further note that this TTM default rate in convertible bonds has been lower than that of high yield in nearly 80% of those rolling periods. Finally, we note that convertible bonds can complement an allocation to traditional credit given the asset's skew toward growth and innovation over value and cyclicals prevalent in the U.S. high yield market, for example.

**Figure 3. Convertible Bonds’ Implied Spreads Show a Potential Pickup Versus High Yield**

**CONVERTIBLE BONDS VS US HY BB**
(AS OF 5/31/2022)

- **Bloomberg Non-IG Cvt OAS vs. Bloomberg US HY BB Index OAS**
- Current: 297bps as of 05/31/2022
- Median: 187bps
- High: 364 bps as of 05/29/2020
- Low: 58 bps as of 04/30/2018

**CONVERTIBLE BONDS VS US HY B**
(AS OF 5/31/2022)

- **Bloomberg Non-IG Cvt OAS vs. Bloomberg US HY B Index OAS**
- Current: 113bps as of 05/31/2022
- Median: 41bps
- High: 201 bps as of 06/15/2020
- Low: -88 bps as of 09/30/2015

Source: Bloomberg. Data as of 5/31/2022. Bloomberg U.S. High Yield (HY) BB Index and Bloomberg U.S. High Yield B Index are ratings-specific components of the Bloomberg U.S. High Yield Index. Bloomberg Non-IG Cvt=non-investment grade portion of the Bloomberg U.S. Convertibles Index. OAS=Option-adjusted spread, which is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

Past performance is not a reliable indicator or guarantee of future results.

**Key Takeaways**

If the hotter-than-expected May inflation report is any indication, investors may adopt a more defensive posture as we await the outcome of the Fed’s campaign to tame inflation by tightening financial conditions without inducing recession. In the meantime, we believe Lord Abbett’s strength in fundamental research across the capital structure, including deep resources in leveraged credit research, could potentially benefit investors given the bond-like nature of the convertible bond market today. On the flip side, periods when macro growth is scarce have historically seen growth-oriented equity strategies outperform value. That environment could also present a positive backdrop for the underlying equities of many of the innovative convertible bond issuers we have seen over the past several years. Either way, Lord Abbett’s convertible bonds team has a long history of successful active management through a variety of market and economic conditions and will bring that experience to bear in today’s challenging environment.
Unless otherwise noted, all discussions are based on U.S. markets and U.S. monetary and fiscal policies. Asset allocation or diversification does not guarantee a profit or protect against loss in declining markets. No investing strategy can overcome all market volatility or guarantee future results. The value of investments and any income from them is not guaranteed and may fall as well as rise, and an investor may not get back the amount originally invested. Investment decisions should always be made based on an investor’s specific financial needs, objectives, goals, time horizon, and risk tolerance.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Projections should not be considered a guarantee.

Equity Investing Risks

The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. While growth stocks are subject to the daily ups and downs of the stock market, their long-term potential as well as their volatility can be substantial. Value investing involves the risk that the market may not recognize that securities are undervalued, and they may not appreciate as anticipated. Smaller companies tend to be more volatile and less liquid than larger companies. Small cap companies may also have more limited product lines, markets, or financial resources and typically experience a higher risk of failure than large cap companies.

Fixed-Income Investing Risks

The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. Generally, when interest rates rise, the prices of debt securities fall, and when interest rates fall, prices generally rise. High-yield securities, sometimes called junk bonds, carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Bonds may also be subject to other types of risk, such as call, credit, liquidity, and general market risks. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. The securities markets of emerging market countries tend to be less liquid, especially subject to greater price volatility, have a smaller market capitalization, have less government regulation and may not be subject to as extensive and frequent accounting, financial and other reporting requirements as securities markets in more developed countries. Further, investing in the securities of issuers located in certain emerging countries may present a greater risk of loss resulting from problems in security registration and custody or substantial economic or political disruptions.

The credit quality of fixed-income securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor’s, Moody’s, or Fitch, as an indication of an issuer’s creditworthiness. Ratings range from ‘AAA’ (highest) to ‘D’ (lowest). Bonds rated ‘BBB’ or above are considered investment grade. Credit ratings ‘BB’ and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer’s ability to pay interest and principal on these securities.

This material may contain assumptions that are “forward-looking statements,” which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

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Glossary & Index Definitions

A call option, often simply labeled a “call,” is a contract, between the buyer and the seller of the call option, to exchange a security at a set price. Delta represents the sensitivity of the price of a convertible bond to changes in the price of the underlying stock.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates.

The U.S. Federal Reserve (Fed) is the central bank of the United States. The Federal Open Market Committee (FOMC) is the monetary policy-setting arm of the Fed. “Fedspeak” refers to policy-related statements from Fed officials.

The federal funds (fed funds) rate is the target interest rate set by the Fed at which commercial banks borrow and lend their excess reserves to each other overnight.

Growth/Value Investing: Growth stocks may be characterized as equities of companies that have demonstrated better-than-average gains in earnings in recent years and that are expected to continue delivering high levels of profit growth. Growth equities typically carry higher price-to-earnings multiples than the broader market, high earnings growth records, and greater volatility than broader market. Secular growth stocks are stocks of companies whose economic performance is relatively immune to economic cycles. Value stocks may be characterized as equities of companies that have fallen out of favor with investors but still have good fundamentals, or new companies that have yet to be recognized by investors. Value stocks typically feature lower price-to-earnings multiples than the broader market, and, often industry peers; and somewhat lower volatility than the overall equity market.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percent- age point). The option-adjusted spread (OAS) is the measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option. Typically, an analyst uses the Treasury securities yield for the risk-free rate.

The yield on a security is the amount of cash (in percentage terms) that returns to the owners of the security, in the form of interest or dividends received from it.

The Bloomberg U.S. Convertibles Index is designed to represent the market of U.S. convertible securities, such as convertible bonds and convertible preferred stock.

Bloomberg Index Information:

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The ICE BofA U.S. Convertible Index tracks the performance of publicly issued U.S. dollar-denominated convertible securities of U.S. companies.

ICE BofA Index Information:

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The Russell Midcap® Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 31% of the total market capitalization of the Russell 1000 Index. The Russell Midcap® Growth Index measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values.

The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Indexes are unmanaged, do not reflect deduction of fees and expenses and are not available for direct investment.

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