Convertibles: Should You Look at the 2021 Model?

Convertible bonds have had a strong run in 2020. Their long-term return profile, and history of downside protection in market declines, suggests they could be a compelling addition to a portfolio in 2021.

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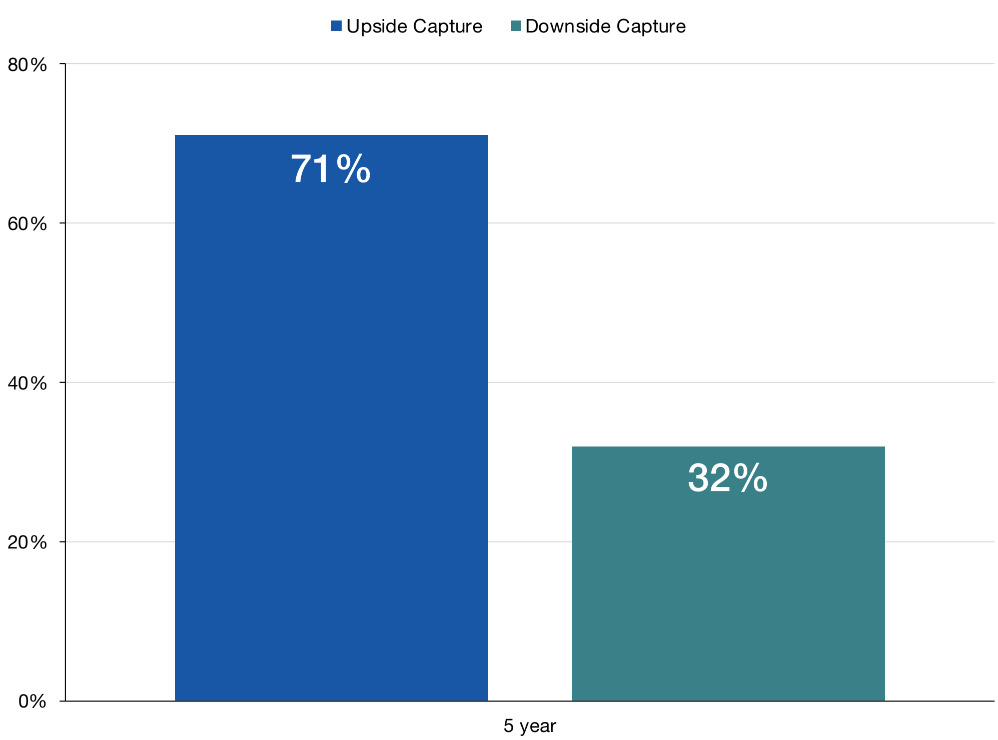
Figure 1. Convertible Bonds Historically Have Offered Downside Protection versus Underlying Equities

Trailing 5-year upside and downside capture ratios versus underlying equities as of September 30, 2020



Sources: ICE Data Indices, LLC, Lord Abbett. Data is the average of the monthly upside capture and downside capture of the ICE BofA All U.S. Convertibles Index versus the underlying equities' returns.

Past performance is not a reliable indicator or guarantee of future results. The historical data shown are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

Convertible Bonds

Convertible bonds represent a relatively small asset class that often gets overlooked by investors. Some are not quite sure how to include convertibles in an asset allocation: Are they stocks or bonds? In what "style box" do they belong? Although they often fly under the radar, "converts" have been gaining attention recently, a result of a surge of issuance and strong performance in pandemic-stricken 2020.

Below, we summarize some key traits of the asset class and outline why convertibles may be worth a fresh look as we approach 2021.

What Are Convertible Bonds?

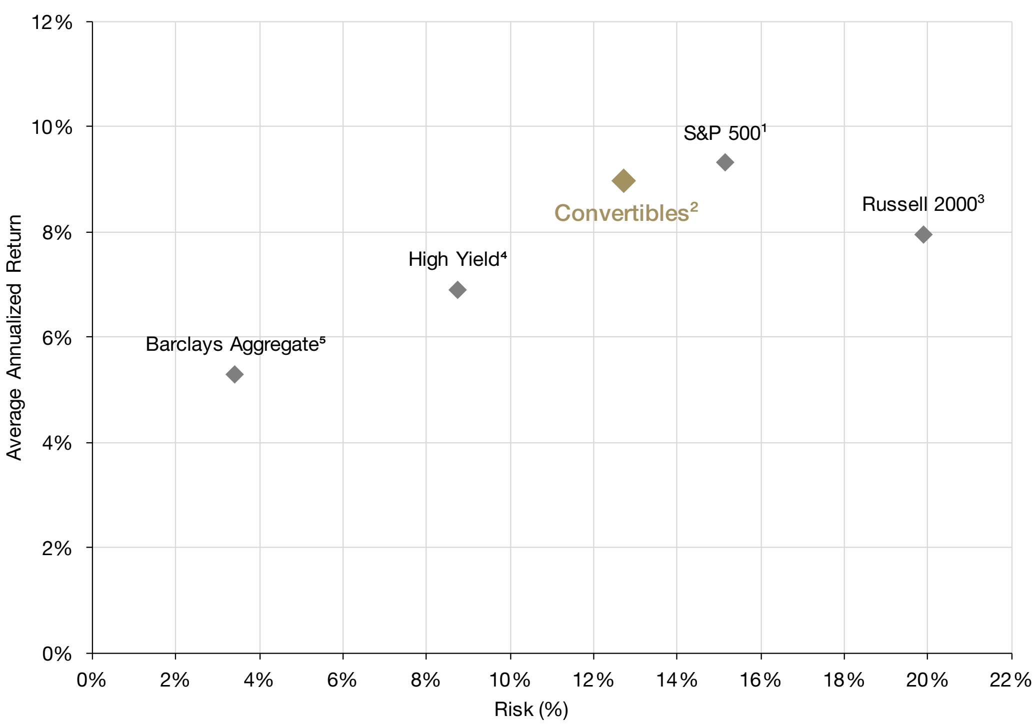
While there are many variations of convertible securities, the basic structure of a convertible bond is a corporate bond (with a fixed coupon and maturity date) that includes an option allowing the holder to convert the bond into common stock of the issuing company at some point in the future. The number of shares each bond can convert into and the conversion price are set at the time of issuance.

What does that lead to? Since the convertible can be exchanged for the underlying equity, they offer the potential to participate in the upside of a rising stock. However, if the underlying equity falls, the convertible still maintains the investment value of the "bond floor," or the value at which a straight bond of the same coupon, maturity, and credit quality would trade. To illustrate the power of this downside protection, over the trailing five years ended 9/30/20, the ICE BofA All U.S. Convertibles Index has captured over 70% of the upside with only 32% downside capture of their underlying equities (see Figure 1).

This structure—which allows for participation in a rising equity market, but provides potential protection when equities decline—has led to attractive risk-adjusted returns over the long-term (see Figure 2).

Figure 2. Historically, Convertibles Have Provided Attractive Risk-Adjusted Returns

Trailing 25-year risk/return for the indicated indexes as of September 30, 2020



[1]S&P 500. [2]ICE BofA All Convertibles, All Qualities Index. [3]Russell 2000 Index. [4]ICE BofA US High Yield Index. [5]Bloomberg Barclays U.S. Aggregate Bond Index.

Source: Morningstar. Data as of September 30, 2020 (latest quarterly). Risk is measured by **standard deviation**, which measures the dispersion of data from the mean. Applied to a rate of return, standard deviation is an indication of an investment's volatility.

Past performance is not a reliable indicator or guarantee of future results. Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment. The historical data from Bloomberg shown are for illustrative purposes only and do not represent any specific portfolio managed by Lord Abbett or any particular investment.

Convertible Bonds: A Diverse, Evolving Universe

A key to understanding convertibles is the broad range of risk-reward opportunities *within* the asset class. One important measure to be aware of is the level of equity sensitivity in a convertible (also known as the *delta*, or the expected percentage change in price of the convertible for a change in the underlying stock). For example, as the price of the underlying stock rises to the point where the option to exchange into the stock is "in the money," the convertible will closely match the price move of the stock (e.g., a convertible with a delta of 1.0 would move in line with the underlying stock).

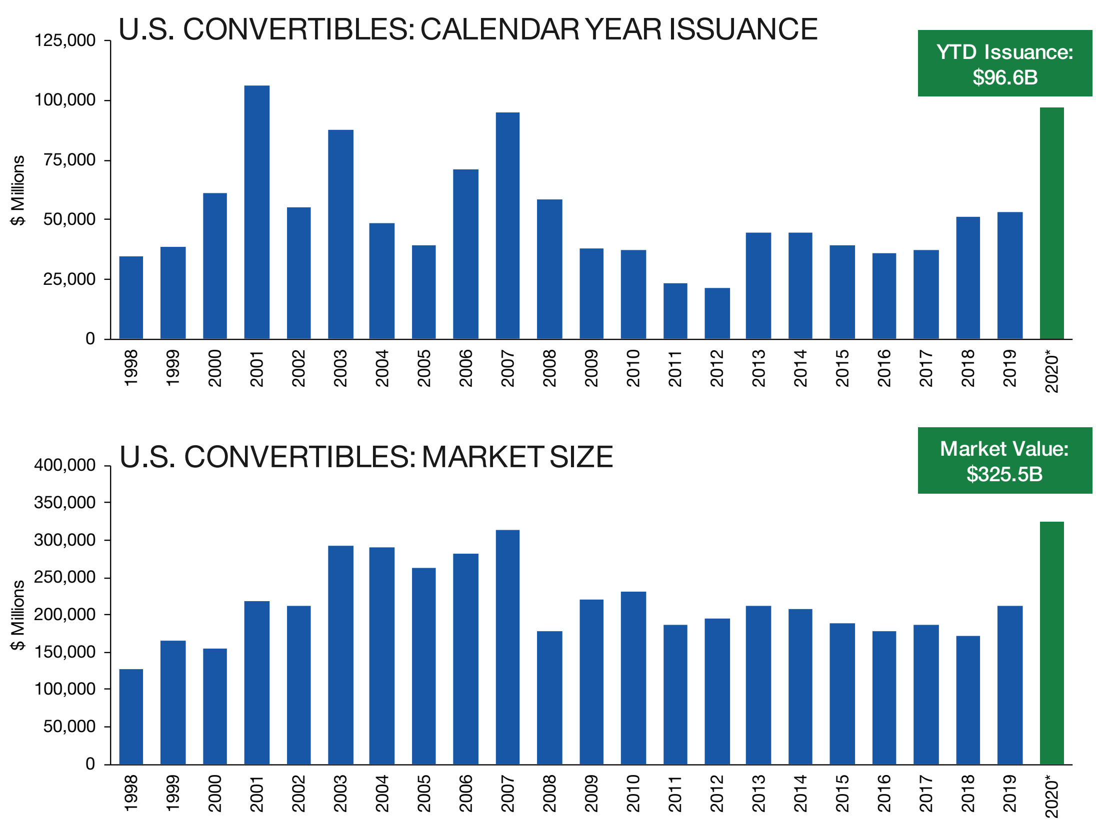
On the other hand, when the option to exchange is very far out of the money, the convertible will be little influenced by movements in the stock and will behave more like a conventional debt instrument. Between the extremes of "equity alternatives" or "yield investments" are "total return" or balanced convertibles, which can exhibit favorable asymmetric upside/downside return profiles.

The asset class also offers exposure to a wide range of investment styles. The ICE BofA All U.S. Convertibles Index is heavily weighted toward growth companies, with about 60% of the underlying equities classified as growth and 20% core. This exposure to innovative growth companies, with nearly half the index in technology and healthcare, has been a strong contributor to returns this year. But the composition of the market is constantly evolving.

With nearly $100 billion in new issuance this year, the largest annual volume in almost two decades (as shown in Figure 3), the total market value of the ICE BofA All U.S. Convertibles Index has reached a record $325 billion.

Figure 3. In 2020, Convertibles See Robust Issuance, 20-Year High in Market Value

Data for the ICE BofA All U.S. Convertibles Index, 1998–2020 (through November 30)



Source: ICE Data Indices, LLC. Based on ICE All U.S. Convertibles Index. Data as of 11/30/2020. For illustrative purposes only.

Downside Protection

While there has been a lot of issuance from the traditional growth sectors, the pandemic led to an uptick in rescue financing and issuance from the more stressed sectors like cruise operators, airlines, and retailers. The uptick in value issuers has resulted in a more balanced market, in our view.

The characteristics outlined above present active managers with a diverse investment universe to uncover opportunities: from higher-yielding, bond-like instruments to high-delta, equity-sensitive convertibles. While the asset class provides exposure to small and mid cap innovative growth companies, managers can rotate to more cyclical exposure and large cap value issuers as opportunities arise. This provides multiple levers for managers to adjust to the market environment, generate alpha, and manage risk.

Portfolio Applications for Today's Market

Although convertibles may not fit neatly into a traditional style box, their attractive risk/reward profile can potentially play a valuable role in a portfolio. Here's why we believe "converts" are particularly relevant in today's market:

1. Reduce equity exposure while maintaining upside potential

With major U.S. equity markets at all-time highs after the surprising rally seen over the past nine months, some investors may want to reduce their equity exposure. Shifting a portion of a portfolio from equities to convertibles provides the opportunity to participate in future equity market gains, while providing downside protection during market pullbacks.

2. Risk-aware allocation to innovative growth companies

Much of the past year has been a tale of two markets, with growth and innovation outperforming value and cyclicality by a wide margin. For those who want exposure to secular growth (including small and mid cap growth) but are concerned about valuations or a shift in sentiment, convertibles may provide a solution. As we noted earlier, convertibles' historical upside/downside capture versus their underlying equities suggests the asset class may be an attractive approach to gain growth exposure while managing risk.

3. Diversify fixed income allocations

In a yield-starved world, investors are looking for new sources of income. The 1.92% yield on the ICE BofA All Convertibles, All Qualities Index compares favorably to the 1.15% yield on the Bloomberg Barclays U.S. Aggregate Bond Index (as of November 30). Convertibles can help diversify fixed-income portfolios since they provide very different sector exposures than traditional corporate credit, which tends to have a more cyclical bias with large weightings to sectors such as energy, basic industry, and financials.

One other consideration: A move to higher rates represents a major potential risk to core fixed-income allocations. While higher rates do not seem to be a concern in the near term, at some point, rates may normalize from their current low levels. Convertibles historically have demonstrated negative correlation with U.S. Treasury bonds and have delivered strong returns during periods of rising Treasury yields. Figure 4, which depicts the performance of various assets during periods of rising rates, shows that convertibles historically have outperformed investment-grade bonds, high-yield bonds, floating-rate loans, and the S&P 500 Index.

Figure 4. Convertible Bonds Historically Have Performed Well During Periods of Rising Rates

Returns during periods when yields on the 10-year U.S. Treasury note rose by more than 100 basis points

Period	10-Year U.S. Treasury[1]	Bloomberg Barclays Aggregate[2]	Floating Rate Loans[5]	High Yield Bonds[6]	Convertible Bonds[7]	S&P 500[8]
09/30/1993 – 11/30/1994	-8.9%	-3.0%	11.3%	1.2%	-2.7%	1.8%
01/31/1996 – 08/31/1996	-6.0%	-1.8%	4.8%	3.1%	5.4%	3.9%
09/30/1998 – 01/31/2000	-7.7%	-0.6%	4.9%	3.7%	41.4%	28.3%
06/30/2005 – 06/30/2006	-5.8%	-0.8%	6.7%	4.7%	9.4%	8.6%
12/31/2008 – 12/31/2009	-9.9%	5.9%	44.9%	57.5%	49.1%	26.5%
08/31/2010 – 03/31/2011	-6.1%	-0.8%	7.4%	10.3%	19.2%	27.8%
07/31/2012 – 12/31/2013	-6.2%	-1.1%	7.0%	9.5%	22.9%	25.7%
06/30/2016 – 12/31/2016	-7.5%	-2.5%	5.4%	7.5%	8.3%	8.1%
Average Return	-7.3%	-0.6%	11.6%	12.2%	19.1%	16.3%

[1]FTSE 10 Year Treasury Bond Index. [2]Bloomberg Barclays U.S. Aggregate Bond Index. [5]Credit Suisse Leveraged Loan Index. [6]ICE BofA U.S. High Yield Constrained Index. [7]ICE BofA All Convertibles, All Qualities Index. [8]S&P 500 Index.

Source: Morningstar. 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. Performance during other time periods may have been different or negative. Other indexes may not have performed in the same manner under similar conditions.

Summing Up

While some investors have passed over convertibles in recent years, strong performance and $100 billion in new issuance in 2020 make it difficult to ignore this hybrid asset class. Whether you are an investor looking to pare back on equity risk, diversify traditional bond portfolios, or access a source of income that may do well during periods of rising rates, it may be time to take a fresh look at convertibles.

A Note about Risk: Convertible securities are subject to the risks affecting both equity and fixed-income securities, including market, credit, liquidity, and interest rate risk. Convertible securities tend to be more volatile than other fixed- income securities, and the markets for convertible securities may be less liquid than markets for common stocks or bonds. High-yield, lower-rated convertible securities carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal.

No investing strategy can overcome all market volatility or guarantee future results.

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

This article 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.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary of Terms

Alpha measures the performance of an investment against a market index or benchmark that is considered to represent the market's movement as a whole.

A **basis point** is one hundredth of one percent.

Bond floor refers to the minimum value a specific **bond**, usually a convertible **bond**, should trade for and is derived from the discounted value of its coupons plus redemption value.

A **convertible bond** is a fixed-income instrument that allows the holder to convert the bond into equity under specific conditions. The basic structure of a convertible bond gives the holder the option to hold the bond until maturity and receive cash par value, or to convert the bond into a specified number of shares of stock of the same company.

Core equities generally refer to stocks of stable, blue-chip companies that represent the more conservative part of an equity allocation.

Coupon is the interest rate stated on a bond when it is issued. The coupon is typically paid semiannually.

Delta refers to the sensitivity of the price of a convertible bond to changes in the price of the underlying stock.

Downside capture: The downside capture ratio measures a manager's performance in down markets relative to a particular benchmark. A down market is one in which the market's quarterly (or monthly) return is less than zero. For example, a ratio of 50% means that the portfolio's value fell half as much as its benchmark index during down markets.

Standard deviation measures the dispersion of data from the mean. Applied to a rate of return, standard deviation is an indication of an investment's volatility.

The Bloomberg Barclays U.S. Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade, fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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The **Credit Suisse Leveraged Loan Index** is designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market.

The **FTSE 10 Year Treasury Bond Index** is a broad measure of the performance of the medium-term U.S. Treasury securities.

The **ICE BofA All U.S. Convertibles Index** consists of convertible bonds traded in the U.S. dollar-denominated, investment- grade, and non-investment-grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value-weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily.

The **ICE BofA All Convertibles, All Qualities Index** contains issues that have a greater than $50 million aggregate market value. The issues are U.S. dollar-denominated, sold into the U.S. market, and publicly traded in the United States.

The **ICE BofA U.S. High Yield Constrained Index** is a rules-based index consisting of U.S. dollar-denominated, high- yield corporate bonds for sale in the U.S. The index is designed to provide a broad representation of the U.S. dollar-denominated, high-yield corporate bond market. The index is a modified market value-weighted index with a cap on each issuer of 2%.

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