Convertibles: What's Driving Investor Interest?

Our experts have identified three themes that underscore the potential appeal of convertible bonds in the current market.

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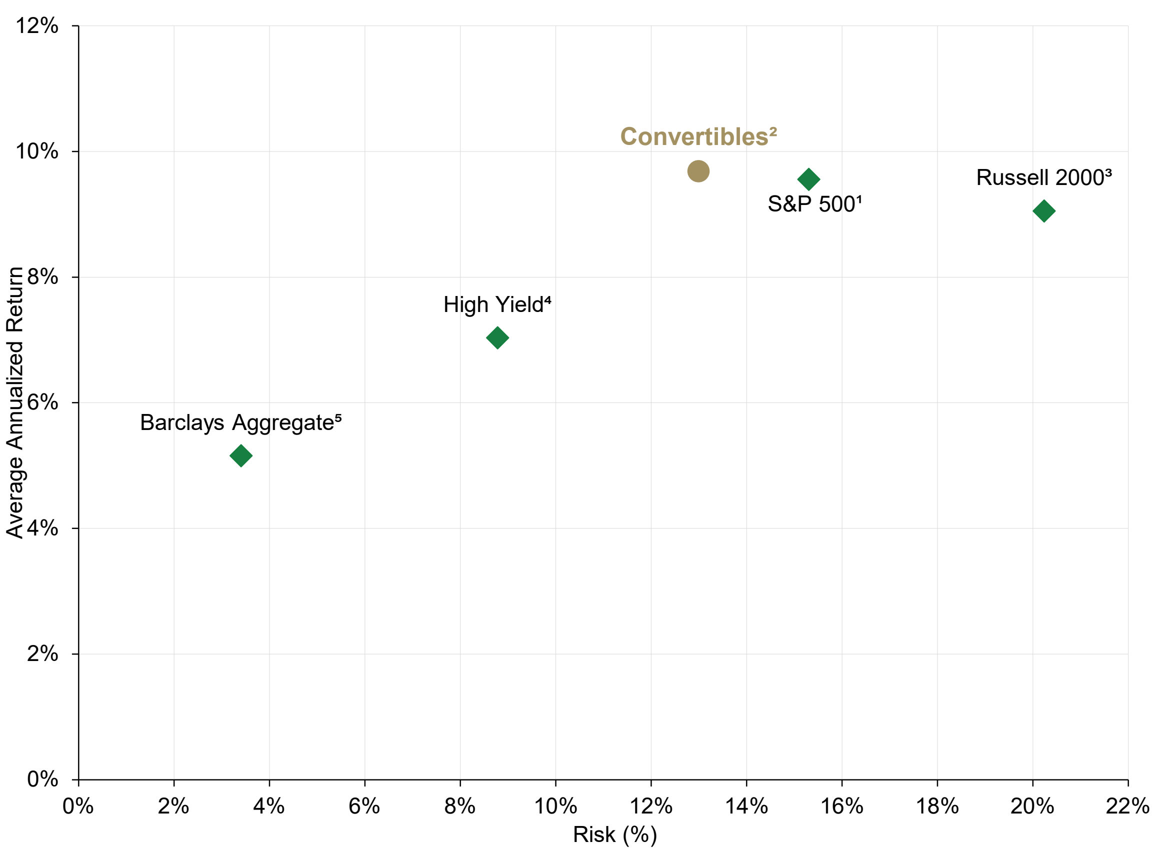
Figure 1. Convertibles Have Delivered Competitive Returns vs. Equities—with Less Risk

Average annualized return and risk (standard deviation) for the indicated indexes for the trailing 25 years through December 31, 2020



Source: Morningstar. [1]S&P 500. [2]ICE BofA All Convertibles-All Qualities Index. [3]Russell 2000® Index. [4]ICE BofA U.S. High Yield Index. [5]Bloomberg Barclays U.S. Aggregate Bond Index.

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.

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CONVERTIBLES

In a recent webinar with investors, a panel of Lord Abbett experts, including Portfolio Managers Alan Kurtz and Jeremy Lehmann and Director and Portfolio Specialist Don Annino, reviewed the recent action in the convertible bond1 market—and identified three themes that may make these securities a potentially attractive choice for investors.

1. A Strong Showing in a Difficult Year

For an asset class that has often been overshadowed by its "parents"—equities and bonds—convertibles attracted a lot of investor attention, and buying, in 2020. The benchmark ICE BofA All Convertibles-All Qualities Index returned 46%, according to Bloomberg data. The growing investor attention was also evidenced by robust convertible issuance, which reached a two-decade high of $106 billion in 2020, based on data from ICE Data Indices. (The trend has continued in 2021, with nearly $9 billion issued through mid-February.)

We think it's worth taking a closer look at that issuance. Part of it came from the secular growth companies in technology and healthcare that have been a staple of the convertible bond market for the past decade. But there was also a significant amount of issuance from industries that were in the crosshairs of the COVID-19 pandemic—for example, airlines, cruise line operators, and brick-and-mortar retail companies. Looking to the rest of 2021, as vaccines are distributed, and economies around the world begin to reopen, we think these industries have the potential to generate earnings at a much greater scale than they were able to do before the shutdown. With the increased diversity of industries represented in the market, we think that the convertible asset class has the potential to perform well in a reopening environment.

One other noteworthy feature of convertibles' performance in 2020 was how they held up during the worst of the COVID-fueled market sell-off in the early part of the year. We have long pointed to the historical resilience of the asset class, as measured by its downside capture during large market sell-offs. Convertibles' performance in 2021 certainly fit in with the long-term trend (see Figure 2).

Figure 2. Historically, Convertible Bonds Have Outperformed Equities in Market Declines

Average Downside Capture for Converts versus the S&P 500: 67%

Max S&P 500 Drawdown Period	S&P 500 Index Return	ICE BofA All Convertible, All Qualities Index Return	Convertibles Downside Capture
10/09/2007 - 03/09/2009	-55.2%	-42.8%	78%
03/24/2000 - 10/09/2002	-47.4%	-38.5%	81%
02/20/2020 - 03/23/2020	-33.8%	-26.8%	79%
07/16/1990 - 10/11/1990	-19.2%	-16.8%	88%
09/20/2018 - 12/24/2018	-19.4%	-12.2%	63%
07/17/1998 - 08/31/1998	-19.2%	-15.0%	78%
04/29/2011 - 10/03/2011	-18.6%	-16.8%	90%
04/23/2010 - 07/02/2010	-15.6%	-9.7%	62%
11/27/2002 - 03/11/2003	-14.2%	0.2%	-1%
11/03/2015 - 02/11/2016	-12.7%	-13.9%	109%
05/21/2015 - 08/25/2015	-11.9%	-9.0%	76%
07/16/1999 - 10/15/1999	-11.8%	-5.3%	45%
10/07/1997 - 10/27/1997	-10.8%	-4.7%	44%
01/02/1990 - 1/30/1990	-10.0%	-4.6%	46%
01/26/2018 - 02/08/2018	-10.1%	-6.2%	61%

Source: Bloomberg. Max intra-year declines, starting January 1, 1990. Start dates inclusive. Downside capture: The downside capture ratio measures an index's performance in down markets relative to a particular benchmark. The historical data are for illustrative purposes only, do not represent the performance of any specific portfolio managed by Lord Abbett or any particular investment, and are not intended to predict or depict future results. 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.**

2. A Strong Historical Track Record

As we said before, an increasing number of investors appear to have taken notice of "converts" after their stellar showing in 2020. But what about the longer term? Convertibles have had an impressive run over the past quarter century, in our view. The asset class historically has delivered returns competitive with equity indexes with significantly less volatility (see Figure 1 on first page).

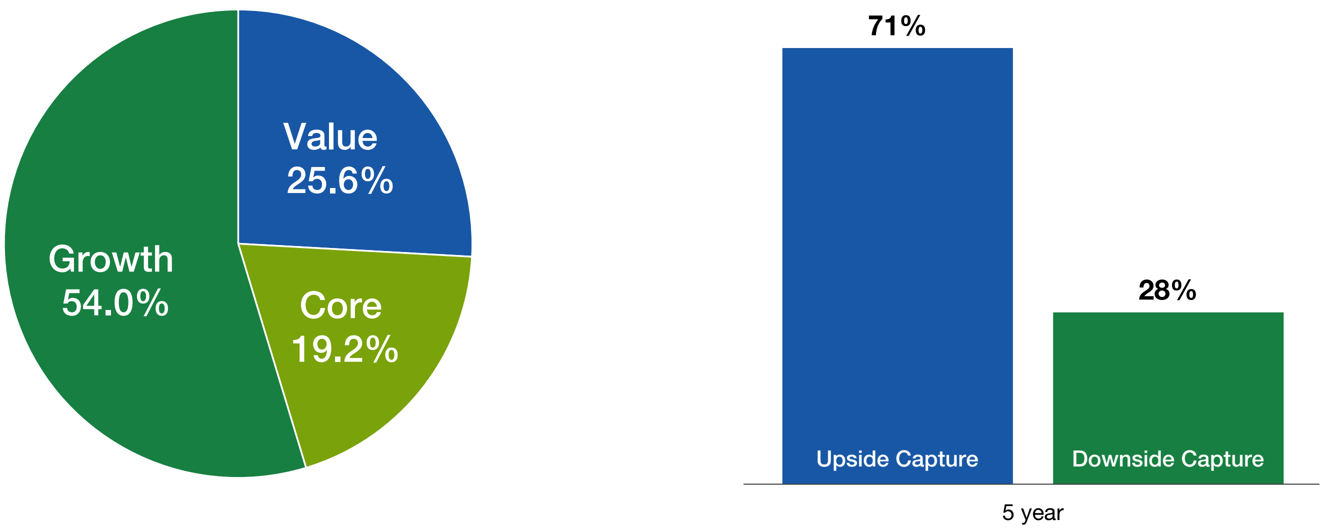
3. Potentially Attractive Positioning for the Future

One other compelling feature of convertibles, in our view, is that the asset class can potentially provide investors with exposure to attractively positioned growth companies, but with a measure of potential downside protection. Figure 3 shows the recent style composition of the ICE BofA All Convertibles-All Qualities Index, coupled with its downside/upside capture versus underlying equities over the five years through December 31, 2020.

Figure 3. Convertibles Offer Exposure to Growth with Potential Risk Mitigation

Style composition for underlying equity issues as of December 31, 2020

Upside/downside capture versus underlying equities for the five years through December 31, 2020



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

In our view, the performance of the convertibles market has been paced by securities issued by what we believe are the next wave of innovative, fast-growing companies. Interestingly, this potentially attractive tilt toward growth has happened without exposure to mega-cap technology companies— i.e., Facebook, Microsoft, Amazon, Netflix, Google, and Apple—none of which have convertible bonds currently outstanding. In fact, the convertible universe most closely aligns to mid-cap-sized companies (40% of the market, according to ICE Data Indices), with small-cap and large-cap representing smaller shares, offering a potentially attractive element of diversification.

[1]As a reminder, 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.

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.

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Glossary of Terms

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

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.

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