Why Convertibles May Make Sense in Today’s Market

An allocation to convertible securities may potentially help mitigate downside risk during volatile times, while allowing investors the opportunity to participate in an equity market recovery.

Figure 1. Convertible Securities Have Become Less Sensitive to Moves in Underlying Equities

*Delta (price sensitivity to underlying stock) for the Bloomberg Barclays U.S. Convertible Index, January 1, 2012-March 31, 2020 (monthly data)*

Source: Barclays Research, Bloomberg Barclays U.S. Convertible Index.

Data as of March 31, 2020. Delta refers to the sensitivity of the price of a convertible bond to changes in the price of the underlying stock; the greater the delta, the greater the price sensitivity. 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.
The coronavirus-induced market volatility has been dramatic, both in terms of magnitude and velocity. The continued uncertainty regarding the path out of this crisis and the social and economic disruptions caused by the global pandemic may have heightened investors' desire to protect their capital, and driven a search for relevant investment opportunities.

Convertible securities have recently, and historically, provided some resiliency to investors during times of elevated market volatility and have generated compelling risk-adjusted returns over the long term. Furthermore, as equity prices have fallen significantly, and credit spreads have widened to levels not seen since the European sovereign debt crisis, convertibles are more attractively valued, in our view. Here, we present three key characteristics of the convertible bond market that we believe make the asset class a potentially attractive allocation in the current investment environment.

1. Lower Equity Sensitivity

The U.S. convertibles market's delta—which measures convertibles' equity sensitivity to their underlying stocks—has fallen significantly during the recent selloff, and as of March 31, 2020, was near its lowest point in the past eight years, based on data from Barclays Research (see Figure 1 on front page). In our view, this is indicative of a more balanced convertibles market, one where price moves are less influenced by the volatility in the equity markets. However, if prices of the underlying stocks move higher as part of a broad equity market recovery, we believe convertibles should take on more stock-like characteristics, participating in the upside.

2. Lower Bond Floor Premium

The bond floor is the minimum value a convertible bond should trade for without the conversion feature (that is, investors' ability to convert the bond to stock under certain conditions). The bond floor premium (or investment value premium) is the difference between a convertible’s market price and its bond floor, and is another way to look at a convertible security’s equity sensitivity.

A higher bond floor premium (further away from the bond floor) means greater equity sensitivity, whereas a lower premium means a more bond-like, less equity-like convertible market. Alongside the decline in delta, data from Barclays Research recently showed that the bond floor premium was recently near eight-year lows. We believe that this is another indication of a more balanced convertibles market, one in which investors experience more potential downside support, while also providing potential opportunity for upside participation when equity markets recover.
3. Higher Average Yield

The decline in convertible bond yields over the past several years coincided with strong appreciation in the prices of the underlying stocks. However, as equity prices have declined, the current yield of the asset class was recently at its highest levels in nearly three years (see Figure 2). With close to US$10 trillion in negative yielding debt globally, and U.S. interest rates near historic lows, the convertible market now boasts a yield advantage over both the investment-grade bond market (as represented by the Bloomberg Barclays U.S. Aggregate Bond Index) and the broad U.S. equity market (as represented by the S&P 500® Index).

A Final Word on Convertible Securities

As investors look to rebalance their portfolios, we believe convertibles may offer a mix of attractive characteristics to encompass a wide range of market scenarios. During a prospective recovery in financial markets, convertibles should offer investors strong upside potential, in our view, benefiting from narrowing credit spreads and rising equity prices. However, if the current market volatility persists, the asset class’s unique characteristics (attractive yield and risk/return profile) may potentially mitigate a considerable amount of the downside compared to traditional equity markets. In our opinion, convertibles’ historically favorable asymmetric risk/return profile is an enticing proposition for investors who seek principle preservation and volatility mitigation, alongside the potential for significant capital appreciation.

Recently, financial markets have been characterized by very wide credit spreads, moderation in equity price-to-earnings multiples, and convertible valuations at levels not seen since 2016. These conditions could potentially act as tailwinds for continued outperformance of convertibles in the near future. We believe there is a strong case to be made for both a tactical and long-term strategic allocation to convertible securities in the current market environment.
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

A basis point is one hundredth of one percent.

Bond floor is defined as 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. The difference between the convertible bond price and its bond floor is the bond floor premium (risk premium), which is the value that the market places on the option to convert a bond to shares of the underlying stock.

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.

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.

The Bloomberg Barclays U.S. Convertibles Index tracks the performance of the USD-denominated convertibles market and includes all four major classes of convertible securities (i.e., cash pay bonds, zeros/OIDs, preferreds, and mandatories).

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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