# Considering a Shift into Convertibles?

With strong year-to-date performance and record issuance, convertible securities may be "having a moment." We believe they remain an attractive choice for investors

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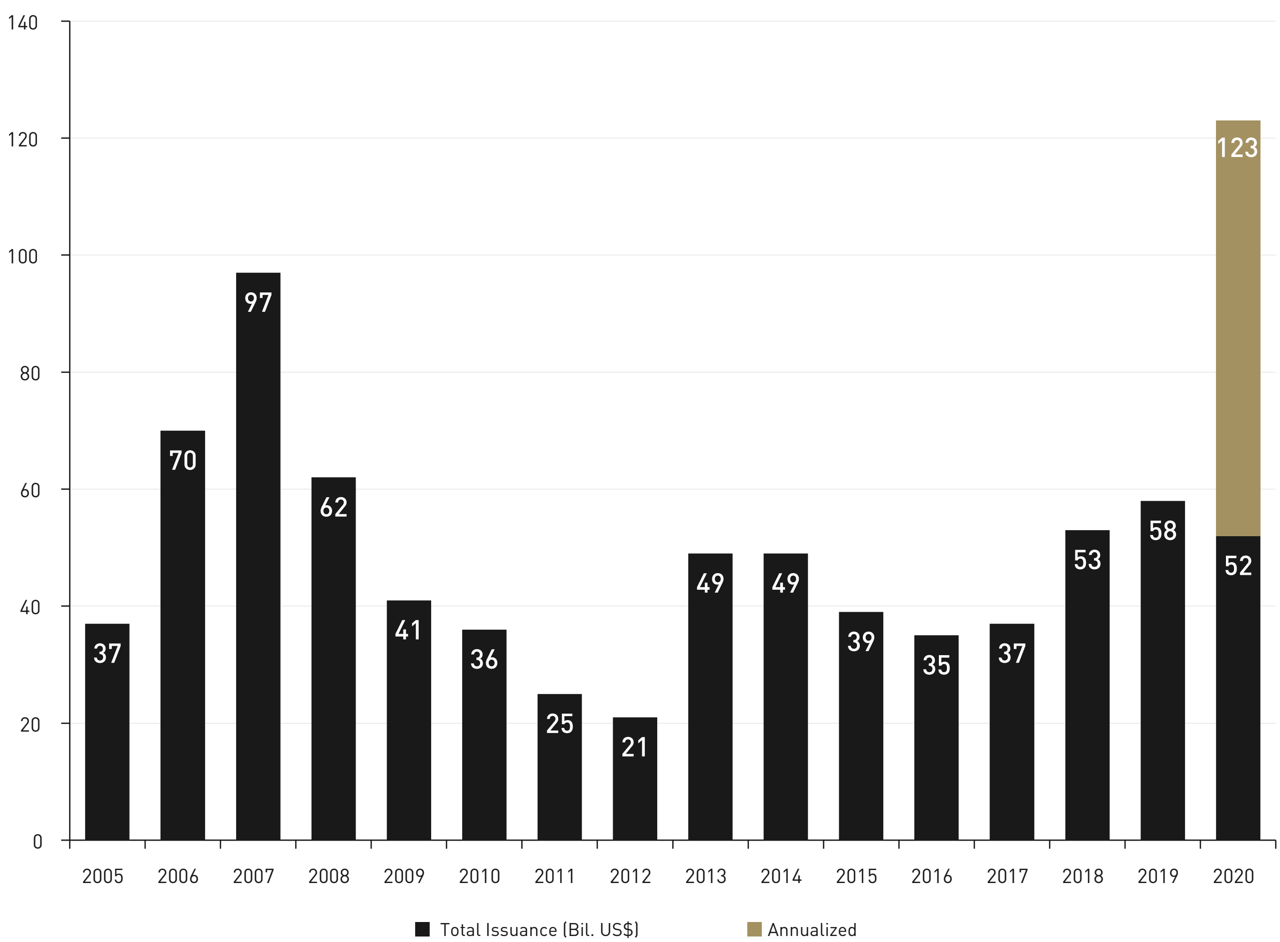
**Figure 1. Convertible Securities are on Pace for Record Issuance in 2020**




Source: Barclays Research. Data as of May 29, 2020.

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 convertible securities market has seen some noteworthy developments thus far in 2020. New U.S. convertible bond issuance hit a monthly record in May 2020, according to Dealogic data cited in a press report.[1] Meanwhile, this often overlooked asset class has significantly outperformed both the S&P 500® Index and the U.S. high yield market (as represented by the ICE BofA US High Yield Index) year-to-date through June 24, on both an absolute and risk-adjusted basis.[2] Furthermore, in a rapidly evolving market environment, one that has seen an historic peak, sudden contraction, and rapid recovery in the span of three months, convertibles have exhibited notable resiliency, in our view.

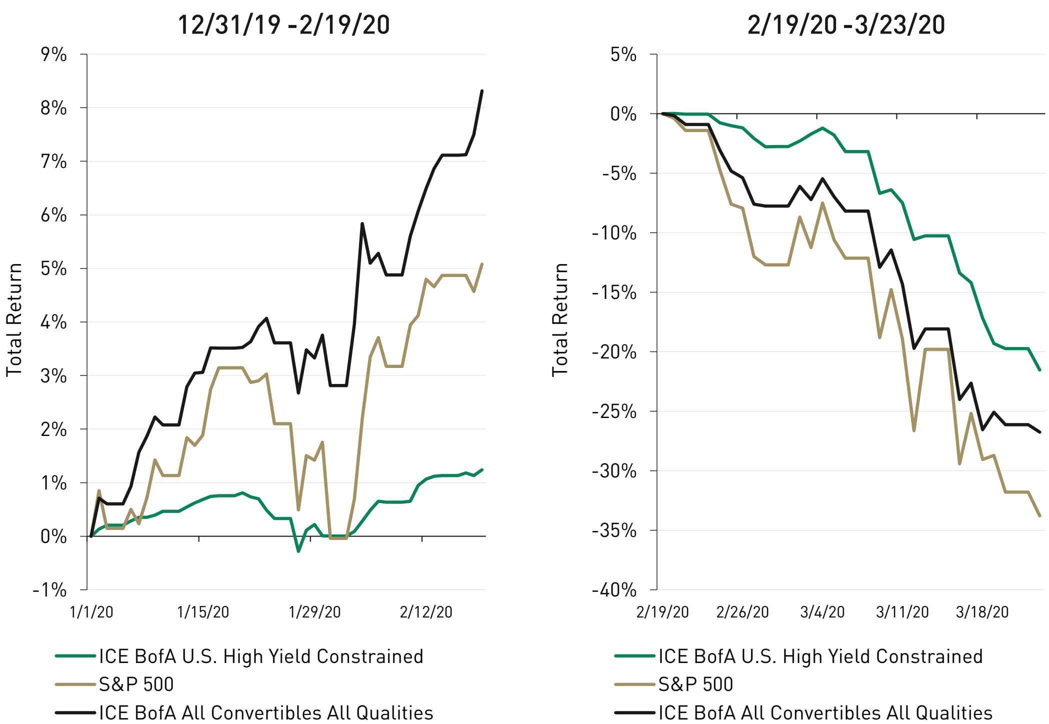
Early in 2020, convertibles were outpacing the broad equity and high yield markets (see left panel of Figure 2), a development we believe was tied to a large representation of innovative sectors and companies within the asset class. As investors wrestled with the uncertainty of the ensuing global pandemic, and asset markets declined at an extraordinary pace, we think the unique structure and profile of convertibles likely helped mitigate some of the impact compared to traditional equities (right panel).

Now, as major equity indices have rebounded sharply, so too has the profile of the convertible bond market. (A recent Bloomberg report said "the securities…have already been having something of a moment" in 2020 in terms of media and investor attention.[3]) Convertibles have captured over 75% of the upside of the equity market during this rapid recovery, based on FactSet data for the period March 23–May 31, 2020. Additionally, the market delta – a measure of convertibles' equity sensitivity to their underlying stocks – was 65 as of June 24, very close to the high of the year, and up from 45 in March. (For more on delta, see the April 27, 2020 Market View.)

## Convertible Issuance at Record Levels

Alongside the asset class's strong relative performance, the convertible market has experienced a surge in new issuance. As noted earlier, the month of May marked the largest issuance on record for the convertible market, and recent market activity suggests the potential for continued strength, in our opinion. (See Figure 1.)

**Figure 2. Convertibles Outperformed Equities Pre-Pandemic, and Offered Less Downside in the Immediate Aftermath**




Source: ICE BofA Indices. Data as of June 25, 2020.
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IN TODAY'S MARKET

Many of the new issuers have come from distressed travel and leisure sectors that have been pressured by the global spread of the novel coronavirus. Nevertheless, the majority of these issues have come to market with what we view as extremely attractive terms. Furthermore, new deals continue to be embraced, as convertible securities' historical characteristics of balanced credit exposure and upside participation in rising equity markets may prove attractive to investors.

According to Barclays Research, post-COVID 19 new offerings are markedly different from prior periods, including sector representation. Before the March 2020 selloff, the largest sectors in the convertible market were Technology (29%), Health Care (19%), and Communications Services (14%). However, in April and May the mix shifted, and the Health Care (29%) and Consumer Discretionary (24%) sectors are now the largest. To us, this indicates further diversification within the convertibles market—and a potential broadening of the opportunity set for investors.

## How Convertibles Could Potentially Play a Part in Investment Portfolios

We think convertibles' performance thus far in 2020 has provided a good illustration of some of their more attractive historical characteristics. The favorable risk-reward return profile and diversified sector and credit exposure of the asset class, especially compared to traditional fixed income markets, has helped convertibles provide investors with downside protection relative to equities at a crucial time, in our opinion. While convertibles have recovered alongside the equity markets, we think that the current moment may still be an attractive entry point for investors. The asset class has benefited from the continued leadership of health care and tech companies—two key areas of innovations—well as the recovery of distressed travel/leisure companies that recently entered the market.

Investors who are looking to get back into the market or add equity exposure may find convertibles, with historically strong risk adjusted returns compared to traditional equites, to be an appealing choice. On the other side, those who may be looking to lower risk and reduce equity exposure after a rapid recovery, may also find convertibles an attractive option as they assess their equity weightings.

As we have noted in the past, investors may wish to consider an actively managed strategy in this space. The unique structure of convertibles may result in misvaluations in the equity, fixed income, or option components of these securities, creating potential opportunities for experienced professional investors.

[1] Aidan Gregory, "US Convertible Bond Market Has Biggest-Ever Month for Issuance," globalcapital.com, June 4, 2020.

[2] Convertible securities' performance represented by the ICE BofA U.S. Convertible Index.

[3] Brian Chappatta, "Robinhood Crowd Misses Out on Convertible Bonds," Bloomberg, June 23, 2020.

**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.

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**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.

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