A new chapter for convertibles
An underrepresented asset class returns to the spotlight

The persistent bull market of both equities and fixed income has left many investors under-allocated in convertible securities ("convertibles"). Naturally, investors have been reluctant to take a haircut with convertibles in the face of a charging bull market, which has been a boon to equities and corporate bonds over the past several years. However, as we confront a climate of rising interest rates and market volatility, we believe that the case for convertibles is compelling. These hybrid securities – which embody the characteristics of both equities and bonds – can smooth out the potential impact of volatility resulting from rising interest rates and/or declining equity prices, thereby allowing investors the opportunity to participate in upside momentum while gaining an important measure of protection in an uncertain market environment. In this paper, we look at why Palisade Capital Management believes that conditions are so favorable for convertibles today.

Convertible securities represent a strategic opportunity for equity investors to mitigate downside risk while still participating on the upside, as well as for fixed income investors to garner yield with the potential for enhanced returns through equity exposure. By exploring how convertibles work, the many benefits of investing in these hybrid securities – particularly in today's markets – become increasingly clear.

1. MORE ROBUST NEW ISSUANCE ANTICIPATED

In recent years, the convertibles asset class hasn't achieved asset growth via new issuance, largely due to the impact of both maturities and redemptions, as well as the continued low-interest-rate environment. When interest rates are extremely low, there is little need for companies to issue convertibles to raise capital. It's considerably easier and cheaper to attain funding by going to market with straight debt instruments at minimal cost to the issuing company. When rates eventually rise, which appears to be the prevailing trend, so too should the issuance of convertibles as a means of raising corporate capital. The ultra-low corporate borrowing costs that characterized the U.S. Federal Reserve Board's ("Fed's") quantitative easing measures should eventually reverse course, which we believe will benefit convertibles.

Demand has already begun to grow for convertibles in response to growing institutional interest. However, the supply of convertibles continues to be constrained, which provides support for the value of convertibles. We believe convertibles have been undervalued of late as a result of the decade-long period of bullishness. As the credit cycle advances, there is evidence that new issuance volume is expanding to accommodate growing demand for growth capital and refinancing, which will likely attract even more investment dollars into the convertibles universe. As of July 31, 2018, 96 convertible bonds have been issued in 2018 worth $38.5 billion.* This is the highest volume of issuance since the financial crisis of 2008.

*Source: Barclays Research
2. THE PREVAILING ENVIRONMENT: TAILWINDS FOR CONVERTIBLES

A rising stock market and declining credit spreads tend to be an environment in which convertible bonds thrive. Historically, we have seen periods, such as 2009, where tightening credit spreads and rising equity markets drove the performance of convertibles, and we are now seeing similar conditions come to the fore. In an environment of positive equity returns and rising interest rates, we believe that convertibles are likely to fare better than their high-yield and investment-grade counterparts.

Since the Fed’s quantitative easing measures ended, interest rates have been rising steadily, particularly at the short end of the curve. The Fed’s course of slow but steady rate increases has played out. The Fed hiked its benchmark short-term rate by 25 basis points in June 2018, with two more hikes anticipated before year-end. Moreover, tax reform and deregulation are providing tailwinds to economic expansion that are supporting the probability of continued gradual interest rate increases and entry into more hawkish territory for the Fed. There has also been an uptick in market volatility, as characterized by a series of surges in the CBOE Volatility Index (VIX) in the first half of 2018 after a prolonged period of relatively stable market conditions. In light of these factors, we believe that convertibles are poised to add value and continue to play a diversifying role in investors’ portfolios.
3. WHY CONVERTIBLES? WHY NOW?

#1 Less sensitivity to a rising interest rate environment

While the expected environment of higher rates is a known detriment to bonds, this is not necessarily the case when it comes to convertibles. If economic conditions are conducive to an appreciation in the value of the underlying equity, convertibles can participate on the upside as a result of their embedded call options.

As the chart below shows, convertibles have historically generated positive returns when interest rates have moved higher by 100+ basis points because their equity optionality reduces duration risk. In the eight periods identified below, convertibles outperformed U.S. bonds by a significant margin and outperformed high-yield bonds in all but two time periods when rates were rising. When rates rose 225 basis points between 1998 and 2000, convertibles actually outperformed high-yield corporate bonds by 36.86 percentage points!
If we examine the current make-up of the U.S. convertibles universe, the market has higher weightings in growth-oriented sectors such as Information Technology and Health Care. These sectors have significantly dominated issuance in 2018. Traditionally, these types of growth-oriented equities are considered less rate-sensitive than those in more defensive sectors, such as real estate investment trusts (REITs) or Utilities.

Furthermore, convertibles are typically issued at a lower tenor (five to seven years) than high-yield bonds (seven to 10 years), which results in lower duration risk than high yield corporate bonds – another important advantage of convertibles if current interest rate patterns persist.

A rising interest rate environment tends to coincide with brisk economic expansion that is generally positive for equities and, accordingly, the equity call option feature of convertibles. Compare this to high yield and other traditional fixed income securities whose prices tend to decline when interest rates rise. As of July 31, 2018, U.S. convertibles are outpacing U.S. stocks, government bonds, and high yield and investment-grade debt.

### #2 Superior downside protection over equities

Looking at the historical monthly performance of convertibles – as measured by the ICE BoA Merrill Lynch All U.S. Convertibles Index\(^7\) – relative to a broad equity index, such as the S&P 500\(^8\), is instructive. As you can see from the chart below, convertibles have the potential to participate in market upside in both bull markets and periods of recovery. On the flipside, they tend to offer greater downside protection during periods of market weakness. With convertibles, investors may obtain equity-like return potential without taking on equity-like risk.
Drilling down further, let's examine the period that covers the beginning of January 1996 through to the end of April 2018. Convertibles had fewer months with negative returns than equities, but the median monthly decline was approximately half that of equities (49.7%). When normalizing the observations to include only those months when equities produced losses, the median monthly decline for convertibles was only 41.1% of equities.

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<tr>
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<th>EQUITY MARKET (RUSSELL 2000®) A</th>
<th>CONVERTIBLES (ICE BAML ALL U.S. CONVERTIBLES INDEX) B</th>
<th>RELATIVE PARTICIPATION B/A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Observations (Months)</td>
<td>268</td>
<td>268</td>
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<tr>
<td>Number of Positive Return Months</td>
<td>165</td>
<td>170</td>
<td></td>
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<tr>
<td>Median Return During Positive Return Months</td>
<td>3.70%</td>
<td>2.19%</td>
<td>59.2%</td>
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</tbody>
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PERFORMANCE DURING POSITIVE RETURN MONTHS FOR RUSSELL 2000®

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<tr>
<th></th>
<th>Number of Positive Return Months</th>
<th>Median Return During Positive Return Months</th>
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<tr>
<td></td>
<td>165</td>
<td>3.70%</td>
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<tr>
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<td>3.70%</td>
<td>2.23%</td>
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<td>60.3%</td>
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Source: Bloomberg, FactSet

#3 – Asymmetric returns help mitigate the impact of market volatility

In volatile equity markets, convertibles' values typically decline at lower rates than the underlying equities due to their unique structural features. If a convertible's underlying equity appreciates in price, the convertible's value also increases owing to the optionality component. Conversely, if a convertible's underlying equity declines in price, the convertible's value moves lower as well. However, the decline of the convertible's value should be less pronounced since there is support from the interest payments and the issuing company's obligation to repay the convertible securityholder at par when the security matures.

Therefore, we believe that convertible securities provide a desirable asymmetry of returns and alpha potential by offering more upside capture and less downside capture as equity markets move higher or lower.

As the following paired charts illustrate, the U.S. convertibles market, which comprises roughly two-thirds of the entire global convertibles market, has generated total returns that are competitive with the S&P 500® Index, with materially lower volatility – as measured by standard deviation – during every indicated period. We believe that the compelling characteristics of convertibles will continue to drive competitive risk-adjusted returns over the long term.

**THE LEVERAGE POTENTIAL OF DELTA**

“Delta” is the degree to which an option participates in the price movement of the underlying stock. For example, assume the underlying stock moves from $20 to $21. If the call option is priced at $2 with a delta of 35%, the option gains 35 cents (i.e., 35% of the $1 stock gain). This means the option rose 17.5% (from $2 to $2.35) while the stock rose 5%. Conversely, if the price of the underlying stock in our example drops $1, the option declines 17.5% while the stock declines 5%. In an environment of rising equity prices, higher-delta call options have the potential to lever up gains. If stocks are weakening, lower-delta call options will decline less than higher-delta options.
4. CONVERTIBLES CAN HELP IMPROVE INVESTORS’ RISK-RETURN PROFILES

In the context of a traditional portfolio of stocks and bonds, convertibles can provide a better return with the same level of risk. As you can see in the chart below, the addition of convertibles to a bond portfolio increases the portfolio's return potential with lower levels of risk than adding equities to the same portfolio, resulting in a more attractive risk-return profile.
5. DIFFERENT WAYS TO ACCESS CONVERTIBLES

Palisade Capital Management's analysis strongly suggests that convertibles can add value as a core part of a diversified portfolio. There are a number of ways to invest in the convertible securities market, depending on an investor's needs:

- A long-only convertibles strategy seeks to generate enhanced returns by exploiting marketplace inefficiencies through mispriced stocks and mispriced convertible securities.

- While long-only strategies remain a staple among Palisade clients within the convertibles space, short-duration convertible strategies are gaining in popularity. Short duration convertibles offer improved liquidity and low-beta, low-volatility securities exposure as compared to traditional long-only portfolios. Short duration convertibles portfolios are also customizable to address specific investor objectives and risk concerns, including worries about equity risk (but still wanting to maintain an equity exposure), or concerns about higher interest rates (but not wanting to add duration).

- A hedged convertibles strategy employs an actively managed (bullish/bearish) hedging approach to convertible securities, placing hedges at both the portfolio and security levels in an effort to produce asymmetric, non-correlated returns with low volatility.

6. VALUE-ADDED ACTIVE MANAGEMENT IS CRITICAL IN THIS CATEGORY

The level of diversification available through convertible security portfolios typically can't be replicated by an individual investor purchasing convertibles for his or her own investment portfolio. When taking relatively small positions in convertibles, individual investors should recognize that inefficient markets and wide bid-ask spreads may have meaningful, potentially negative impacts on their trades in convertibles. We believe that a professionally constructed and actively managed strategy is an efficient, effective way to gain access to all the benefits of a diversified portfolio of convertible securities.
For more information about making convertibles an important component of any diversified portfolio, please contact:

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**About Palisade Capital Management**

Palisade Capital Management, L.L.C. is a fully independent SEC registered investment advisor. The Firm has cultivated a culture of excellence, discipline, and focus since its establishment in 1995. Private ownership allows us to take a long-term investment view and supports our commitment to organizational and staff stability. Our independence drives our singular focus toward what we do best — delivering highly specialized investment advice and personalized service. Through our fundamental, research-intensive culture, we have developed traditional and alternative investment strategies that seek to deliver attractive risk-adjusted returns aligned with our investors’ priorities. Palisade has a diversified client base that includes corporations, public funds, financial institutions, family offices, and individuals.

Headquartered in Fort Lee, New Jersey, Palisade counts many of the largest institutional investors in the United States as clients.
Footnotes:

1 VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options.

2 The Bloomberg Barclays U.S. Capital Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

3 The ICE BofA/Merrill Lynch U.S. Treasury Index is an unmanaged index that tracks the performance of the direct sovereign debt of the U.S. Government.

4 The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stocks listed on the NYSE or NASDAQ. The S&P 500® Index does not have a defined investment objective, nor does it charge fees and expenses.

5 The ICE BofA/Merrill Lynch U.S. Corporate Index is an unmanaged index comprised of U.S. dollar denominated investment grade corporate debt securities publicly issued in the U.S. domestic market with at least one year remaining term to final maturity.

6 The ICE BofA/Merrill Lynch U.S. High Yield Index (H0A0) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. Index data presented herein uses the most recent estimates available.

7 The ICE BofA/Merrill Lynch All U.S. Convertibles Index (VXA0) is a capitalization weighted index consisting of convertible securities designed to represent the universe of U.S. corporate convertible securities.

8 The Russell 2000® Index measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market capitalization and current index membership. Source: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). © LSE Group 2018. FTSE Russell is a trading name of certain of the LSE Group companies. All rights in the Russell 2000® Index (the “Index”) vest in the relevant LSE Group Company which owns the Index. Russell® is a trade mark(s) of the relevant LSE Group company and is used by any other LSE Group company under license. The LSE Group does not accept any liability whatsoever to any person arising out of the use of, reliance on or any error in the Index. The LSE Group makes no claim, prediction, warranty or representation to the suitability of the Index for the purpose to which it is being presented by Palisade Capital Management, L.L.C.

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