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CONVERTIBLE SECURITIES

A Message from Senior Portfolio Manager Bill Lee

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Convertibles: Uniquely Positioned to Address Today's Investor Concerns

Today's investors have been confronted with the following conundrum:

- How best to position a portfolio for higher interest rates?
- How to protect existing gains should equity markets decline?
- How to produce gains should equity markets rise?

Conventional wisdom would suggest some combination of fixed income and equity securities with periodic rebalancing to address these issues. While a traditional approach has merits, we believe that convertible securities could offer a unique alternative that addresses these concerns more directly while also providing diversification benefits.

An Underutilized Investment Tool

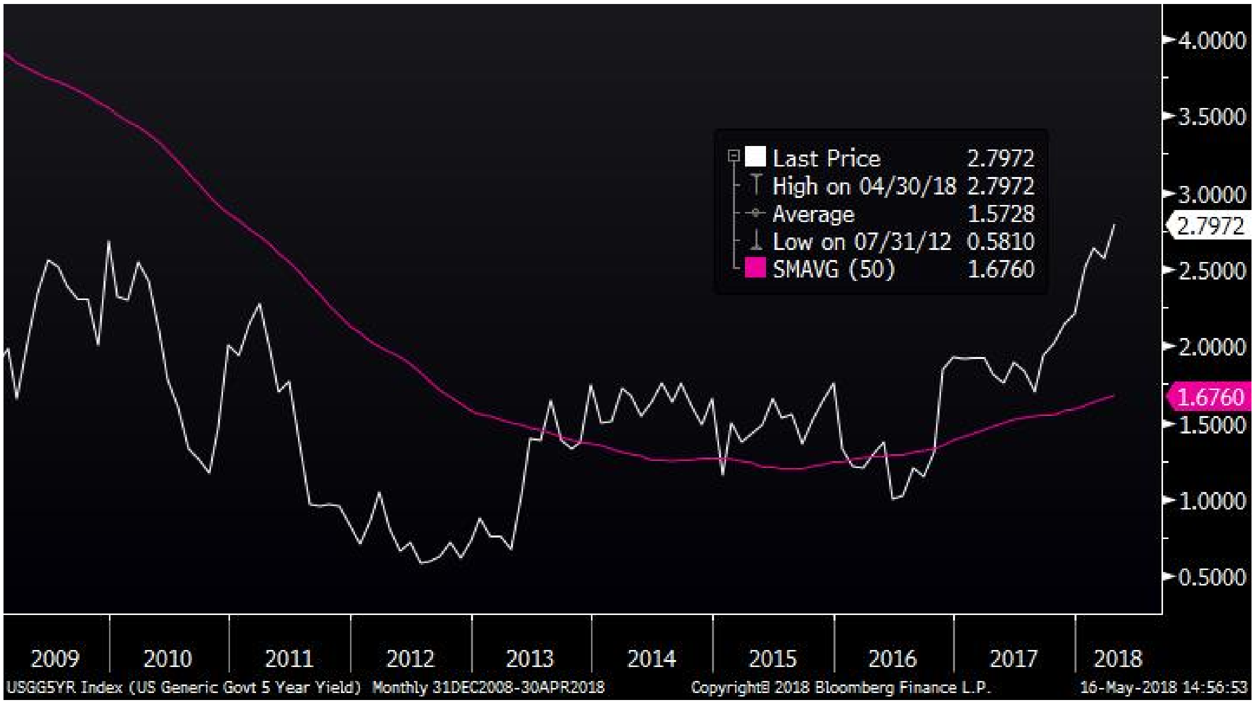
Convertibles embody characteristics of both stocks and bonds. They are securities (typically bonds or preferreds) issued by a corporation (with regular coupons/dividends, stated maturities, and capital structure seniority) that can be converted into common stock of the company. They typically offer higher yields than common stock dividends and lower yields than corporate bonds. However, unlike straight bonds, there is potential for price appreciation through the embedded equity call option that can increase the value of the underlying convertible asset. As a result, convertibles can offer a unique hybrid tool in portfolio diversification, particularly as the prospects of higher interest rates and elevated volatility increase.

Historical Performance of Convertibles is Compelling

In the following pages, we walk you through the current backdrop for interest rates, the historical outperformance of convertibles (relative to other fixed income asset classes) in higher rate environments, and how the convertible asset class works in both up and down equity markets.

What Happens if Interest Rates Rise?

Investors are right to be concerned about rising interest rates. Since 2013 when the end of Quantitative Easing resulted in the so-called "Taper Tantrum", interest rates in the United States, especially on the short end of the curve, have been steadily rising (see below for a chart of the 5-year Treasury yield).



Source: Bloomberg

Combine the Federal Reserve's adherence to a policy of slow and steady rate increases with an economy quickening from tax reform and deregulation, and the likeliest scenario is that interest rates are going to move higher. Higher rates represent a headwind to the performance of fixed income investments and rate-sensitive equity sectors such as REITs and Utilities. Convertibles, meanwhile, may benefit from higher interest rates if equities are viewed as benefitting from greater pricing power and accelerating economic activity. In that scenario, the call option embedded in convertible securities allows for upside participation along with the underlying stock. The table below shows the performance of convertibles and other fixed income asset classes during periods when yields [on 10-year Treasuries] have increased 100 bps or more.

	12/1995 to 8/1996	9/1998 to 1/2000	10/2001 to 3/2002	5/2003 to 6/2006	12/2008 to 12/2009	8/2010 to 3/2011	7/2012 to 12/2013	7/2016 to 1/2017
Yield Increase (bps)	137	225	116	177	162	100	156	100
Bloomberg Barclays U.S. Aggregate	0.28	1.06	0.14	2.47	9.09	0.50	-0.17	-2.34
ICE BofA Merrill Lynch U.S. High Yield	6.57	3.65	7.82	9.35	62.57	10.44	10.37	8.92
ICE BofA Merrill Lynch All U.S. Convertibles	9.03	40.51	5.99	10.18	51.74	17.68	21.98	11.14

Source: Bloomberg, Factset

We believe that convertibles provide additional structural benefits in a higher rate scenario. First, convertibles as an asset class tend to have lower duration (interest rate risk) and generally offer greater liquidity than other fixed income securities. Second, the current universe of U.S. convertibles has higher weightings in growth-oriented sectors such as Technology and Healthcare, whose companies are generally considered less rate-sensitive than those in the

REIT or Utilities sectors. These factors (less duration, better liquidity, and a less rate-sensitive sector composition) are positives for investors seeking some mitigation from the risk of higher interest rates.

What Happens if Equity Markets Decline?

As discussed, convertibles are hybrid securities - meaning that in different market environments, convertibles can act more like fixed income or alternatively, more like equity. In weak equity markets, convertibles values will decline, but at a lower rate than the underlying equities. Convertible values are generally supported by an investor's expectation to receive par value at stated put or maturity dates. This downside protection is a structural benefit that tends to be undervalued, especially during periods of persistent bullishness such as occurred during the last several years.

Examining the historical monthly performance of convertibles (as measured by the ICE BAML All U.S. Convertibles Index) relative to a broad equity index such as the Russell 2000® offers some insight. The period from the beginning of January 1996 through to the end of April 2018 encompasses 268 months.

	Equity Market (Russell 2000®) [A]	Convertibles (ICE BAML All US Convertibles Index) [B]	Relative Participation [B / A]
Number of Observations (Months)	268	268	
Number of **Negative** Return Months	103	98	
Median Return During Negative Return Months	(3.86%)	(1.92%)	49.7%
Performance During **Negative** Return Months for the Russell 2000®			
Number of Negative Return Months	103		
Median Return During Negative Return Months	(3.86%)	(1.59%)	41.1%

Not only did convertibles have 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.

What Happens if Equity Markets Rise?

In rising equity markets, the value of convertibles will rise, but at a lower rate than the underlying equities. As the underlying equities rise, the call options embedded in convertibles increase in value such that the "as if converted" equity value may represent a level much higher than par value.

Again, examining the historical monthly performance of convertibles (as measured by the ICE BAML All U.S. Convertibles Index) relative to a broad equity index such as the Russell 2000® provides meaningful information. As before, we examined the period from the beginning of January 1996 through to the end of April 2018.

	Equity Market (Russell 2000) [A]	Convertibles (ICE BAML All US Convertibles Index) [B]	Relative Participation [B / A]
Number of Observations (Months)	268	268	
Number of **Positive** Return Months	165	170	
Median Return During Positive Return Months	3.70%	2.19%	59.2%
Performance During **Positive** Return Months for the Russell 2000®			
Number of Positive Return Months	165		
Median Return During Positive Return Months	3.70%	2.23%	60.3%

Over this observation period, convertibles produced five more months of gains than equities (170 versus 165) with median monthly gains that were 59.2% of the gains in equities. When normalizing the observations to include only those months when equities produced gains, the median monthly gain for convertibles was 60.3% of equities.

Viewed in the aggregate, therefore, convertibles have historically provided more upside participation during rising markets than downside participation during declining markets. This asymmetry of return is a unique structural benefit of convertibles that benefits investors over time and becomes more evident during periods of heightened volatility.

Palisade Capital Management's Convertible Securities Solutions

Palisade Capital Management's Convertible Securities strategies emphasize the unique benefits of convertibles across a Long-only Unconstrained strategy, a Hedged Convertibles strategy, and a Short Duration Convertible Bond strategy, each of which seeks to utilize convertibles to generate asymmetric return profiles while mitigating specific risks including interest rate, credit, and equity exposures.

Disclosure:

The Bloomberg Barclays U.S. Capital Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. The ICE BofA/ML U.S. High Yield Master II Index (H0A0) tracks the performance of U.S. dollar denominated below investment grade corporate debt publicly issued in the U.S. domestic market. The ICE BofA/Merrill Lynch All U.S. Convertibles Index is a capitalization weighted index consisting of convertible securities designed to represent the universe of U.S. corporate convertible securities. 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 a combination of their market cap and current index membership. The performance and volatility of the strategies described herein will be different than those of any index.

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