

Convertible Investment Study

Style and Market Capitalization Analysis

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In January 2021, Palisade Capital Management published a research piece entitled “*The Time For Convertibles Is (Still) Now*”, where we outlined the advantages of investing in the convertible asset class, both historically and tactically, given an impending, post COVID-19 economic cycle.

In this study, we seek to touch upon and update key aspects of Palisade's unique approach to investing in convertibles. Palisade's convertible strategies emphasize Growth convertibles (as opposed to Value convertibles) and Large- and Mid-Capitalization convertibles (rather than Small-Capitalization convertibles). The basis for this methodology was derived from an exhaustive review of the U.S. convertibles universe in white papers we published in 2012:

Conclusion 1: Growth Convertibles Consistently Outperform

Conclusion 2: Small Capitalization Convertibles Significantly Underperform in Down Markets

GROWTH CONVERTIBLES CONSISTENTLY OUTPERFORM

Since our publications in 2012, there is an additional eight years of data upon which to judge our original conclusions. As presented in the below table, Growth convertibles have outperformed Value convertibles in every year since 2012, extending the streak of years of consecutive outperformance to twenty-three. In 2015, when the overall convertible asset class produced a negative return, Growth convertibles posted a positive return. In the six years where convertibles had an annual decline, Growth convertibles outperformed their Value counterparts. On average, Growth convertibles have produced an annual return of +18.4% versus a more modest +2.1% for Value convertibles. Based on this data, our thesis is consistent with our original conclusion.

Year	Convertible Index (VXAO)	Growth (VGRO)	Value (VVAL)	Annual Outperformance (VGRO – VXAO) (in bps)	Annual Outperformance (VGRO – VVAL) (in bps)
1998	8.9%	21.4%	-5.8%	1,248	2,720
1999	39.6%	68.5%	-9.2%	2,893	7,769
2000	-10.0%	-9.3%	-11.7%	71	238
2001	-4.4%	-3.2%	-6.4%	126	327
2002	-8.6%	-5.0%	-11.6%	362	665
2003	27.1%	32.7%	21.2%	552	1,148
2004	9.6%	15.2%	5.7%	559	955
2005	1.0%	7.2%	-4.2%	619	1,138
2006	12.8%	16.9%	9.0%	410	792
2007	4.5%	9.7%	-0.9%	517	1,061
2008	-35.7%	-26.4%	-43.2%	929	1,682
2009	49.1%	61.6%	35.2%	1,246	2,634
2010	16.8%	24.4%	9.7%	759	1,468
2011	-5.2%	-1.5%	-8.4%	366	683
2012	15.0%	20.6%	9.8%	567	1,087
2013	24.9%	37.2%	13.3%	1,226	2,386
2014	9.4%	12.5%	5.3%	308	718
2015	-3.0%	6.8%	-12.0%	982	1,882
2016	10.4%	16.3%	5.7%	586	1,056
2017	13.7%	16.1%	11.2%	238	486
2018	0.2%	4.1%	-4.1%	390	813
2019	23.2%	24.1%	22.0%	91	209
2020	46.2%	73.2%	16.8%	2,698	5,636
Average	10.7%	18.4%	2.1%	771	1,633
Median	9.6%	16.1%	5.3%	559	1,061
Range (Max)	49.1%	73.2%	35.2%	2,893	7,769
Range (Min)	-35.7%	-26.4%	-43.2%	71	209
Positive Years	17	18	12	23	23
Negative Years	6	5	11	0	0

Source: ICE BofA

The most impactful aspect of this data is both the consistency and magnitude by which Growth convertibles have outperformed Value convertibles. During the period 1998 through 2020, there have been annual periods where Value equities outperformed Growth equities. For example, in 2000, the S&P 500® Value Index gained +6.08% while the S&P 500® Growth Index declined -22.08%. During that same year, the Russell 2000® Value Index rose +22.83% while the Russell 2000® Growth Index fell -22.43%. Yet, within the convertible asset class, Growth convertibles actually bested Value convertibles by declining less during 2000. This consistency of outperformance combined with absolute levels of performance (Growth average annual outperformance of 1,633 bps versus Value) is the primary driver for why Palisade seeks to emphasize Growth convertibles in its convertible strategies.

The case for Growth convertibles is just as compelling when looking at the data in quarters instead of years. Over the last 95 quarters (the full history of 23 years and 3 quarters), Growth convertibles outperformed Value convertibles in 78 quarters (82%). Growth convertibles did not lag Value convertibles for more than two consecutive quarters. Further, Growth convertibles, both on an annual and quarterly return basis, have higher upside (max range) and lower downside (min range or max drawdown), meaning that the risk/return dynamic derived from the structural asymmetry of convertibles may be best represented in the Growth segment.

Deep fundamental credit research complements the tilt toward Growth convertibles as we seek to ensure the securities within the portfolio are able to pay their principal at maturity.

Quarter	Convertible Index (VXAO)	Growth (VGRO)	Value (VVAL)	Quarterly Outperformance (VGRO – VXAO) (in bps)	Quarterly Outperformance (VGRO – VVAL) (in bps)
4Q20	19.67%	21.19%	17.91%	151	327
3Q20	13.93%	20.47%	5.67%	654	1,479
2Q20	24.15%	32.81%	13.32%	865	1,949
1Q20	-13.62%	-10.67%	-17.25%	295	658
4Q19	7.38%	9.27%	4.79%	189	448
3Q19	0.15%	-2.30%	3.51%	-246	-581
2Q19	3.85%	4.54%	3.01%	68	152
1Q19	10.26%	11.17%	9.16%	91	201
4Q18	-9.31%	-9.67%	-9.11%	-36	-56
3Q18	3.93%	6.17%	1.42%	224	475
2Q18	3.77%	4.93%	2.52%	117	241
1Q18	2.40%	3.39%	1.50%	99	190
4Q17	1.56%	1.05%	2.06%	-51	-101
3Q17	3.77%	4.58%	2.97%	80	161
2Q17	2.46%	2.77%	2.21%	31	56
1Q17	5.30%	6.89%	3.54%	159	334
4Q16	2.10%	3.11%	1.16%	101	195
3Q16	6.02%	8.76%	3.79%	274	497
2Q16	3.64%	5.42%	2.21%	178	321
1Q16	-1.56%	-1.63%	-1.47%	-7	-16
4Q15	0.85%	2.77%	-1.30%	192	407
3Q15	-7.14%	-6.58%	-7.61%	56	103
2Q15	0.56%	3.75%	-2.41%	319	615
1Q15	3.02%	7.25%	-1.11%	424	836
4Q14	1.62%	2.26%	0.78%	64	148
3Q14	-1.66%	-0.51%	-3.10%	115	258
2Q14	4.97%	5.39%	4.13%	42	126
1Q14	4.33%	4.95%	3.58%	62	137
4Q13	6.02%	7.57%	4.44%	155	313
3Q13	7.17%	11.29%	2.77%	412	852
2Q13	2.21%	4.25%	0.18%	204	407
1Q13	7.56%	9.91%	5.39%	235	452
4Q12	2.80%	2.91%	2.62%	11	29
3Q12	4.92%	5.51%	4.37%	59	114
2Q12	-3.29%	-1.01%	-5.38%	228	437
1Q12	10.22%	12.24%	8.31%	201	392
4Q11	4.29%	6.12%	2.61%	183	351
3Q11	-12.94%	-13.40%	-12.52%	-47	-88
2Q11	-0.61%	0.36%	-1.46%	97	182
1Q11	5.07%	6.78%	3.62%	171	316
4Q10	7.45%	10.51%	4.78%	306	572
3Q10	9.21%	11.26%	7.13%	206	413
2Q10	-5.80%	-5.22%	-6.48%	58	126
1Q10	5.64%	6.71%	4.48%	107	224
4Q09	5.98%	8.11%	3.67%	213	444
3Q09	16.29%	19.37%	13.01%	308	636
2Q09	17.71%	16.82%	18.60%	-89	-178
1Q09	2.80%	7.19%	-2.67%	438	985
4Q08	-18.63%	-16.99%	-20.66%	164	367
3Q08	-17.56%	-10.68%	-23.12%	689	1,244
2Q08	1.52%	5.32%	-1.72%	380	704
1Q08	-5.61%	-5.79%	-5.34%	-18	-46

Quarter	Convertible Index (VXA0)	Growth (VGRO)	Value (VVAL)	Quarterly Outperformance (VGRO – VXA0) (in bps)	Quarterly Outperformance (VGRO – VVAL) (in bps)
4Q07	-3.25%	-2.15%	-4.58%	109	243
3Q07	1.01%	2.69%	-0.93%	169	362
2Q07	4.35%	5.89%	2.84%	154	305
1Q07	2.50%	3.10%	1.93%	60	117
4Q06	5.01%	5.65%	4.38%	64	127
3Q06	2.79%	3.37%	2.18%	58	119
2Q06	-0.74%	-0.49%	-1.15%	25	67
1Q06	5.32%	7.60%	3.41%	228	419
4Q05	0.46%	3.91%	-2.51%	345	642
3Q05	4.15%	6.40%	2.14%	226	426
2Q05	1.28%	2.20%	0.56%	93	164
1Q05	-4.67%	-5.13%	-4.31%	-46	-82
4Q04	6.64%	8.55%	4.76%	191	379
3Q04	-0.83%	-1.10%	-0.52%	-27	-59
2Q04	-0.57%	-0.24%	-0.89%	34	66
1Q04	4.24%	7.56%	2.29%	332	527
4Q03	8.48%	9.28%	7.62%	80	166
3Q03	2.78%	4.23%	1.15%	145	308
2Q03	10.63%	11.47%	9.61%	84	186
1Q03	3.07%	4.49%	1.57%	142	292
4Q02	8.78%	11.74%	5.87%	296	587
3Q02	-8.18%	-5.93%	-10.21%	225	428
2Q02	-7.61%	-8.62%	-6.27%	-101	-235
1Q02	-0.94%	-1.06%	-0.79%	-12	-26
4Q01	6.99%	10.29%	1.46%	330	884
3Q01	-8.96%	-10.18%	-7.81%	-122	-237
2Q01	4.37%	6.86%	1.01%	249	585
1Q01	-6.01%	-8.55%	-0.98%	-254	-756
4Q00	-12.16%	-14.40%	-6.72%	-225	-769
3Q00	1.08%	1.29%	0.76%	21	53
2Q00	-6.34%	-6.90%	-5.22%	-56	-168
1Q00	8.23%	12.38%	-0.85%	415	1,323
4Q99	24.83%	37.52%	-2.00%	1,269	3,953
3Q99	-1.24%	2.24%	-8.26%	349	1,050
2Q99	7.35%	8.80%	4.81%	145	399
1Q99	5.46%	10.15%	-3.63%	468	1,378
4Q98	13.77%	20.31%	4.04%	653	1,626
3Q98	-11.16%	-9.30%	-14.02%	187	473
2Q98	-0.76%	1.59%	-1.76%	236	335
1Q98	8.60%	9.51%	7.20%	91	231
4Q97	-0.92%	-1.78%	-0.35%	-86	-143
3Q97	10.00%	11.08%	8.58%	108	250
2Q97	9.35%	9.15%	10.01%	-20	-86
Average	2.6%	4.3%	0.6%	166	365
Median	3.0%	4.6%	1.5%	145	305
Range (Max)	24.8%	37.5%	18.6%	1,269	3,953
Range (Min)	-18.6%	-17.0%	-23.1%	-254	-769
Positive Years	67	69	57	78	78
Negative Years	28	26	38	17	17

Source: ICE BofA

SMALL CAPITALIZATION CONVERTIBLES SIGNIFICANTLY UNDERPERFORM IN DOWN MARKETS

The case to underweight small capitalization convertibles has also been supported by historical data. The market capitalization ranges for convertibles are different relative to the market capitalization for their underlying equity securities. The ICE BofA Small Cap U.S. Convertible Index (VSML) includes convertibles with a market cap less than \$1 billion, the ICE BofA Mid Cap U.S. Convertible Index (VMID) includes convertibles with market caps between \$1 billion and \$5 billion, and the ICE BofA Large Cap U.S. Convertible Index (VLRG) includes convertibles with market caps greater than \$5 billion. The table below presents the performance of Small-Cap convertibles versus Mid- and Large- Cap convertibles on an annual basis. Since 2012, the Convertibles Index was only negative in a single year—2015. During that year, Small-Cap convertibles lost -19.8%, materially underperforming Mid- and Large-Cap convertibles. Over the last 23 years, Small-Cap convertibles lagged the broader Convertible Index in 20 of those years (87% of the time).

Year	Convertibles Index (VXAO)	Small Cap (VSML)	Mid Cap (VMID)	Large Cap (VLRG)	Annual Outperformance (VXAO - VSML) (in bps)
1998	8.9%	-8.1%	-2.1%	18.4%	1,700
1999	39.6%	-17.9%	11.7%	57.7%	5,746
2000	-10.0%	-28.2%	-17.8%	-4.3%	1,816
2001	-4.4%	-4.6%	-1.8%	-5.0%	15
2002	-8.6%	-18.7%	-8.7%	-5.5%	1,008
2003	27.1%	36.8%	32.7%	22.5%	-970
2004	9.6%	8.6%	8.9%	10.2%	100
2005	1.0%	-9.5%	4.0%	1.9%	1,056
2006	12.8%	6.6%	13.2%	13.8%	622
2007	4.5%	-10.2%	5.4%	6.1%	1,472
2008	-35.7%	-52.7%	-36.4%	-27.8%	1,694
2009	49.1%	58.8%	53.0%	45.3%	-967
2010	16.9%	14.7%	19.2%	16.0%	214
2011	-5.2%	-18.7%	-3.1%	-3.8%	1,356
2012	15.0%	9.4%	14.2%	16.4%	551
2013	24.9%	15.2%	22.8%	27.4%	969
2014	9.4%	-13.2%	0.4%	17.3%	2,261
2015	-3.0%	-19.8%	-8.1%	2.8%	1,681
2016	10.4%	2.8%	11.4%	11.6%	760
2017	13.7%	10.8%	6.6%	17.7%	294
2018	0.2%	0.8%	-0.5%	0.5%	-65
2019	23.2%	15.3%	21.7%	24.8%	781
2020	46.2%	13.4%	28.3%	56.2%	3,278
Average	10.7%	-0.4%	7.6%	13.9%	1,103
Median	9.6%	0.8%	6.6%	13.8%	969
Range (Max)	49.1%	58.8%	53.0%	57.7%	5,746
Range (Min)	-35.7%	-52.7%	-36.4%	-27.8%	-970
Positive Years	17	12	15	18	20
Negative Years	6	11	8	5	3

Source: ICE BofA

OUTLOOK

We believe the convertible asset class is dynamic as the universe of issuers today is different from both 10 and 20 years ago. Yet as we review the updated data presented above, Growth and Large- and Mid-Capitalization convertibles have outperformed consistently and by a wide margin. The evidence since we originally presented our case has only strengthened over time and as such, we intend to continue our current focus on Growth and Large- and Mid-Capitalization convertibles in all our convertible strategies.

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The ICE BofA All U.S. Growth Convertible Index (VGRO) and the ICE BofA All U.S. Value Convertible Index (VVAL) are categorized by ICE BofA based on Price/Earnings and Price/Book of the underlying stocks. Constituents of VGRO tend to have a higher Price/Earnings and Price/Book combination and constituents of VVAL have a lower Price/Earnings and Price/Book combination.

The ICE BofA Small Cap U.S. Convertible Index (VSML) consists of convertible securities in the VXA0 whereby the convertible issuer has an equity market cap value of less than \$1 billion.

The ICE BofA Mid Cap U.S. Convertible Index (VMID) consists of convertible securities in the VXA0 whereby the convertible issuer has an equity market cap value between \$1 billion and \$5 billion.

The ICE BofA Large Cap U.S. Convertible Index (VLRG) consists of convertible securities in the VXA0 whereby the convertible issuer has an equity market cap value of greater than \$5 billion.

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