THE TIME FOR CONVERTIBLES IS (STILL) NOW

An Asset Class for the New Economic Cycle

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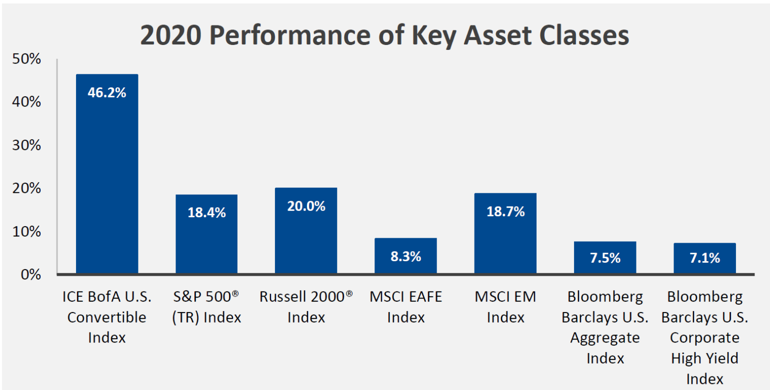
In 2020, as the COVID-19 pandemic spread, the U.S. equity markets experienced historic levels of volatility. The CBOE Volatility Index® ("VIX"), which measures the stock market's volatility expectation, hit its highest ever recorded level in March, while the S&P 500® Index sharply declined 34% from its February high to its March low, then quickly rebounded to finish the year up 18.4%. In our paper "*The Time for Convertibles is Now*; An Asset Class for Periods of Uncertainty and Volatility", we argued that this volatility, together with the expanding universe of convertible issuances and the concentration of technology and healthcare issuers in the convertibles market, created an optimal environment for the asset class. Our view played out through the course of 2020 as U.S. convertibles outperformed every other asset class – the ICE BofA U.S. Convertible Index (the "Convertible Index") was up a staggering 46.2% for the year, posting its best year since 2009.

We believe 2021 will be another favorable year for convertibles and remain a compelling asset class, especially for those that have reexamined their allocation framework and appetite for risk given the rollercoaster ride of 2020. The hybrid nature of the asset class, coupled with the environment of persistent, sustained higher volatility, continued expansion of the convertibles market, and change in composition of the convertibles market (specifically the growth and relative size of the Technology, Healthcare, and Consumer Discretionary sectors) all support convertibles having a strong year in 2021.

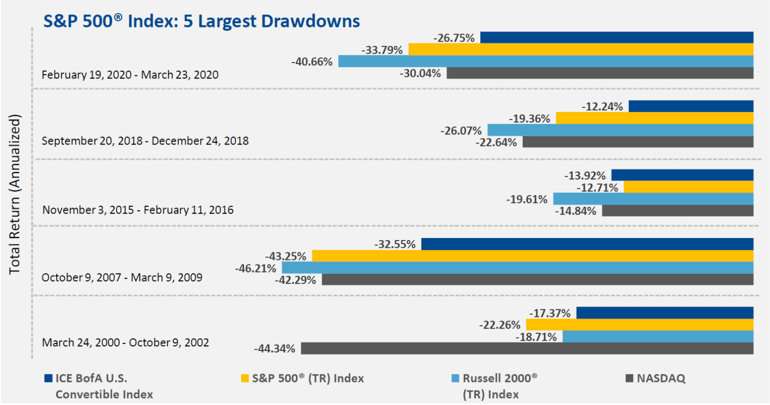


Source: FactSet Research Systems, Inc.

PARTICIPATION WITH PROTECTION

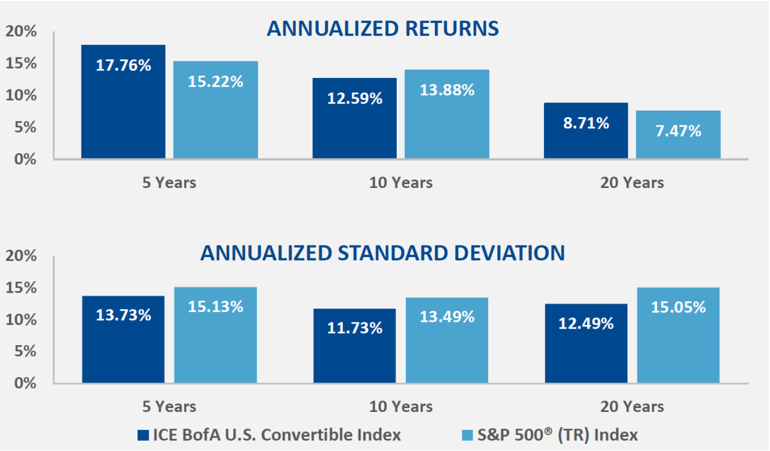
COVID-19 has left an indelible mark on all facets of life and, at the end of 2020, economic recovery began accelerating with the availability of vaccines. It is hard to imagine not wanting to participate in the upside of the "re-opening" but also wanting to take a measured approach that seeks to mitigate risk. The structural nature of convertible securities provides investors with a desirable asymmetry of returns and alpha potential by offering more upside participation and less downside capture as equity markets move higher or lower.

If a convertible's underlying equity appreciates in price, the convertible's value also increases and it behaves like equity due to the call optionality (the ability of the holder to exchange the convertible for a predetermined number of common shares). In down equity markets, a convertible's value will move lower as well. However, the convertible benefits from its bond-like characteristics in a down market – the decline of the convertible's value is less pronounced because its price is supported by interest and principal repayment obligations. This was clearly seen in the most recent market drawdown, which spanned from February 19, 2020 through March 23, 2020. The Convertible Index was down 26.75% during this period, while all major equity indices declined by significantly greater amounts with the S&P 500® Index dropping 33.79%. Lower down-side capture has been seen through drawdown periods for the last twenty years.



Source: FactSet Research Systems, Inc.

Obtaining additional risk protection typically requires giving up some measure of performance – the standard risk/return trade-off. However, over the long-term, the U.S. convertible market, as represented by Convertible Index, has generated total returns that are competitive with the S&P 500® Index. Specifically, over the recent 10-year period convertibles have performed comparably to the S&P 500® Index and over the recent 5-year and 20-year periods they have outperformed the S&P 500® Index. More importantly, the performance of convertibles has been achieved with noticeably lower risk and lower volatility as measured by standard deviation – challenging the standard thinking that investors need to sacrifice return to gain risk protection.



As of December 31, 2020. Source: FactSet Research Systems, Inc.

As we head into 2021, scientific progress to combat COVID-19 fostered a bullish market sentiment but uncertainty remains concerning the timing and duration of the economic recovery. 2020 has taught us it is critical to always be prepared for the unforeseen (and unimaginable). The hybrid nature of convertible securities, with their ability to participate in upside appreciation, provide downside protection for unexpected scenarios, and offer competitive risk-adjusted returns over the long term, should be considered as a critical asset class within any portfolio.

RIGHT PLACE, RIGHT TIME

The hybrid structure of convertibles makes them a compelling asset class in virtually any market environment. However, the 2021 environment makes convertibles even more attractive as the benefits of their structure can be further exploited by persistent, elevated market volatility, the augmented convertibles universe (which continues to grow), and the change in composition of the marketplace to favor the Technology, Healthcare, and Consumer Discretionary sectors – sectors we believe will lead the market in 2021.

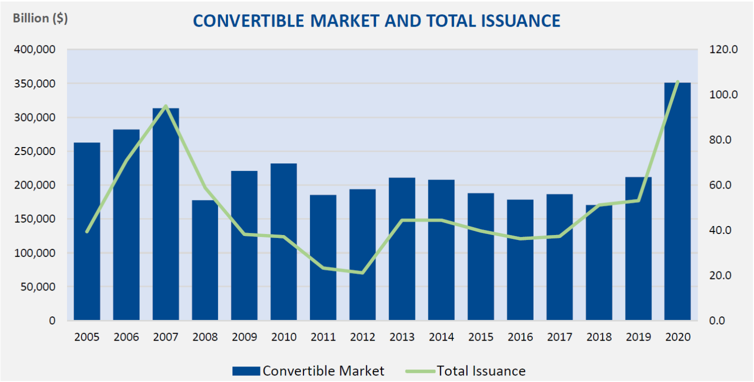
Volatility's New Normal

2020 concluded and 2021 began with an overarching bullish theme and a broadening risk appetite in both the equity and credit markets. However, volatility as measured by the VIX did not return to pre-COVID-19 levels at the end of the year. As of December 31, 2020, the VIX was 22.75 – materially higher than the 10-year trailing average of 17.54 and the 2019 average of 15.43. This new period of sustained, heightened volatility is likely to persist and will be favorable for convertibles.

As noted above, during rising equity markets a convertible's embedded call option will cause the security's value to rise, albeit typically at a slower and less pronounced pace than the underlying equity. When there is higher volatility in the underlying equity, the value of the call option increases – higher volatility improves the chances for equity appreciation and makes the call option worth even more. We believe investors can take advantage of heightened volatility in a risk-managed manner by incorporating convertibles into their portfolio.

Expanding Universe of Solid Credits with Liquidity

The trends of 2020 concerning the size of the convertibles market, quality of credits, and enhanced liquidity all contributed to the outsized success of the asset class. While we believe these trends will slow down in 2021, they will continue to support this compelling asset class.



Source: BofA Merrill Lynch Global Research, ICE Data Indices, LLC, Bloomberg & Barclays Research

2019 had been the strongest year for convertible new issuances since 2008 and the financial crisis, and as we entered 2020 we believed the convertibles market was trending larger. That trend exploded in 2020 with convertible new issuances up 99% from the prior year – 190 convertible new issuances raised $105.8 billion. This explosion of new issuance resulted in the size of the convertibles market hitting an all-time high of $351 billion with a more diverse range of issuers. Although 2021 will not likely keep pace with 2020 in terms of new convertible issuances, we do believe the market will remain robust and active.

Although many companies turned to the convertibles market in the depths of the pandemic as a source of "rescue" financing (*i.e.*, the hard-hit airline, travel and leisure, and retail industries), convertible issuers are not solely comprised of failing credits seeking the market of last resort. Quite the contrary, many companies such as technology and healthcare issuers, among others, used convertibles to raise capital opportunistically. In fact, according to Barclays research, 36% of convertible bond issuers (*i.e.*, 102 out of 285 issuers, as of December 31, 2020) did not have any loans or straight debt outstanding within their capital structure at the time of their convertible issuance.

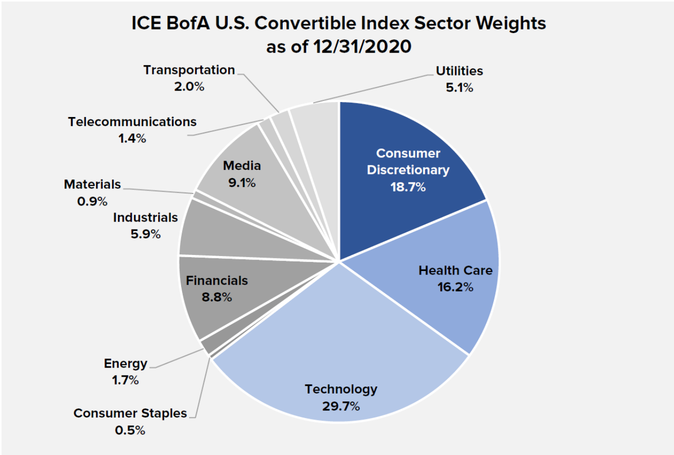
Liquidity is also strong in the convertibles market and increasing with 72% of 2020's new issues being greater than $250 million in size. As compared to other asset classes, convertible bonds tend to be more liquid than high yield bonds as turnover of convertible bonds improved to 3.06x versus high yield's turnover of 1.78x as of the end of the third quarter of 2020. This is partially due to the hybrid nature of convertibles which straddle liquidity characteristics of equity and fixed income. In addition, trading volumes of convertibles experienced a big uptick in 2020 with daily trading volumes exceeding the three-year average on 81% of trading days.

Favorable Sector Exposure

Not only has the convertibles universe grown, but the asset class is oriented to the sectors we believe will lead the market through 2021 and capitalize on the reopening theme – Technology, Healthcare, and Consumer Discretionary.

Technology and Healthcare sectors, which as of December 31, 2020 comprised nearly 50% of the Convertible Index, made up less than 14% of the ICE BofA High Yield Index. If these sectors continue to power the market in 2021, convertibles will exhibit greater upside participation while maintaining structural downside protection.

In addition, Consumer Discretionary companies were active issuers of convertibles in 2020 and at year-end made up over 18% of the convertibles universe – up from 8% of the universe at the end of 2019. The size of asset class's exposure to Consumer Discretionary, together with Industrials (at 6%), should enable the asset class to take advantage of the re-opening (and value) theme in the market as vaccines become more widely available.

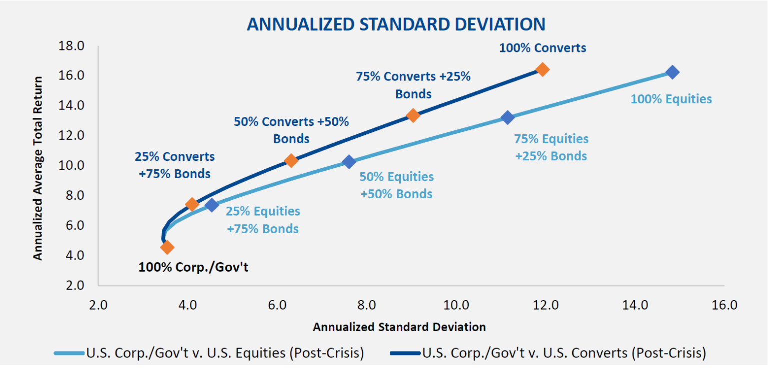


Source: ICE BofA

STRATEGIC ALLOCATION TO CONVERTIBLES

We believe the benefits offered by convertibles can be used in a variety of ways to diversify a portfolio and add value as an independent part of any strategic asset allocation, especially as we embark on the new economic cycle ushered in by COVID-19.

ICE BofA constructed two hypothetical sets of "efficient" portfolios using post-crisis annualized returns (since 2009).



The hypothetical historical performance in the chart above is not an indicator of future actual results.

As of December 31, 2020. Source: ICE BofA Global Research, ICE Data Indices, LLC

An efficient frontier analysis illustrates that an investor would have needed to take on higher levels of risk to achieve the same return when employing a stock and bond portfolio versus a convertible and bond portfolio. For example, to achieve an annualized return of about 10%, a portfolio of convertibles and bonds would have a standard deviation of around 6% while a portfolio of stocks and bonds would have a noticeably higher standard deviation of around 7.5%. Accordingly, adding convertibles to a bond portfolio increases the portfolio's return potential with lower levels of risk than adding equities to the same portfolio. Therefore, we generally recommend that a new allocation to convertible securities come from the aggressive income or equity portion of an existing portfolio. There is also an added benefit of dampened volatility to the overall portfolio since convertibles do not move in perfect unison with stocks and bonds.

Investors may also consider adding convertibles as part of their Alternative allocation given that convertibles tend to be more highly correlated with equities and high yield bonds, while offering low correlations to investment grade bonds.

CONCLUSION

Convertible securities outperformed all other asset classes in 2020 and we believe 2021 will be another strong year. An outright allocation to convertible securities can provide investors with the best of all worlds – favorable asymmetry of returns by participating in upside momentum with an important measure of downside protection. This optimal risk-reward profile will likely be further enhanced given the higher levels of sustained market volatility, expansion of the convertibles market with a diverse array of solid issuers, and significant representation of the Healthcare, Technology, and Consumer Discretionary sectors – sectors we believe will drive the market in 2021.

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The Cboe Volatility Index® (VIX) measures the market's expectation of future volatility. The VIX Index is based on options of the S&P 500® Index, considered the leading indicator of the broad U.S. stock market. The VIX Index is recognized as the world's premier gauge of U.S. equity market volatility.

The ICE BofA U.S. Convertible Index (VXA0) is a capitalization weighted index consisting of convertible securities designed to represent the universe of U.S. corporate convertible securities. Index data presented herein uses the most recent estimates available. Index performance is shown strictly for the purpose of comparison between the Strategy and the VXA0. It is not possible to invest directly in the VXA0. The performance and volatility of the Strategy will be different than those of the VXA0.

The ICE BofA 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. Index performance is shown strictly for the purpose of comparison between the Strategy and the ICE BofA U.S. High Yield Index. It is not possible to invest directly in the ICE BofA U.S. High Yield Index. The performance and volatility of the Strategy will be different than those of the ICE BofA U.S. High Yield Index.

The S&P 500® (TR) Index is an unmanaged index that is widely recognized as an indicator of general market performance. The S&P 500® (TR) Index does not have a defined investment objective, unlike the other indices, nor does it charge fees and expenses. The S&P 500® (TR) Index is shown for illustrative purposes only.

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 cap and current index membership.

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The MSCI EAFE Index is designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada. It covers approximately 85% of the free float-adjusted market capitalization in each country.

The MSCI Emerging Markets (EM) Index captures large and mid cap representation across 27 Emerging Markets (EM) countries. With 1,397 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

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

The Bloomberg Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market.

The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock market.