With equity markets near all-time highs and yields on fixed income near historical lows, investors are rightly concerned. Two major worries permeate investor sentiment:

First, “Am I adding equity at the top of the market?” As measured by the S&P 500 Index, the equity market ended the second quarter at an all-time high. Stocks have rallied for the last five years and the S&P 500 has now delivered six consecutive quarters of gains. Is a correction in stocks likely?

Second, “Are record low interest rates set to finally rise?” The Federal Reserve’s accommodative policies have helped keep interest rates low. As the labor markets and the economy improve, and interest rates increase, will the 30-year bull market in bonds finally give way?

While these two questions will only be answered over time, convertible bonds may offer investors a reasonable alternative given current market conditions.

Because convertibles are hybrid securities (part equity/part fixed income), they have structural benefits that provide equity exposure while maintaining the capital preservation characteristics of fixed income instruments.

So what exactly are convertible bonds? Simply put, they are fixed income securities that generally pay a predetermined coupon, offer a set maturity date, and have a conversion feature that provides for the convertible to be exchanged into a fixed number of shares of the issuer’s common stock at the investor’s option (this is known as the “conversion ratio”).

Convertible bonds are structured so that they offer measured participation as common equities move higher, but generally depreciate by a smaller amount than their underlying stocks if common equity prices decline. This performance profile is referred to as “convexity” and is illustrated by the graph below:

**Convertible Bond Convexity Graph**

*Source: Barclays Convertible Research*
While this chart may appear complicated, the payoff scenarios are fairly simple. If a convertible’s underlying equity appreciates, the value of the convertible also increases (as the ability to convert into a fixed number of common shares at a higher price means the convertible has a higher value). Likewise, as a convertible’s underlying equity declines, the convertible’s value also moves lower, albeit at a slower rate, since the coupon (interest) rate and the issuer’s obligation to repay the holder at par upon the bond’s maturity cushions the convertible’s valuation.

In other words, convertibles offer an asymmetric return: more upside participation than downside as equity markets move up or down. For investors who want to participate with rallying equity markets, but simultaneously want some level of protection should equity markets decline, the structural features of convertible bonds offer an attractive investment alternative.

To further illustrate the point, the Exhibit A shows the performance of the Bank of America/Merrill Lynch All U.S. Convertibles Index (the “Index”), which represents the vast majority of the convertibles traded in the U.S. market, compared with the stocks underlying the convertible bonds that comprise the Index.

As the table shows, the upside capture (i.e., the percentage by which convertible securities increased in value relative to their underlying stock price increases) ranged between 101.4% in 1998 and 24.1% in 2005. The average upside capture for the analyzed period was 73.7%, which is in-line with the 70%-75% upside capture that we have observed for convertibles over the long-term. At the same time, the table illustrates that downside capture (i.e., the percentage by which convertibles declined in value relative to their underlying stock price decreases) ranged between 24.1% in 2002 to 72.4% in 2008. The average downside capture was 44.0% for the period.

Convertibles are also impacted by volatility (i.e., the standard deviation of returns), which is one critical determinant of the fair value, or theoretical price, of a convertible bond. During market corrections, the volatility of stocks increases. As volatility increases, all other things being equal, the fair value of a convertible will actually increase, resulting in a relatively more attractive security for investors.

Clearly, convertibles offer benefits in uncertain equity markets. However, convertibles also appear well positioned in light of the potential for higher interest rates. Because of their increased sensitivity to their underlying equity following years of rising stock prices, a convertible’s sensitivity to higher interest rates (or “duration”), is lower than the duration of most non-convertible bonds. Historically, during periods of rising interest rates, convertibles have actually performed well, as rising rates have been coincident with strong equity markets.
Investors are increasingly becoming aware of these benefits as fund flows into the asset class have turned positive over the last 12 months. Despite increasing investor demand, the supply of convertibles still remains constrained. The convertible bond market has been shrinking for the last several years as the retirement of securities due to maturities, redemptions, conversions, puts, and tender offers have overwhelmed new convertible issuance. As the chart presented below shows, the pace of new issues declined for five consecutive years from 2008 through 2012. This was due, in part, to issuers being able to garner low interest rates in straight debt markets.

Convertible bond new issue activity picked up again in 2013 as strong investor demand allowed for lower coupons and higher conversion premiums. The strong pace of convertible new issuance has continued through the first half of 2014. Based on Barclays’ observations, they project, as illustrated in the graph below, that 2014 new issuance will be slightly greater than in 2013.

Annual Convertible New Issuance — 2007 through 2014 (June 30th)

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Source: Barclays Convertible Research
All convertible bonds have nuances and they are not uniform investment instruments. As the underlying stock price changes, the sensitivity of the bond to movement in the underlying stock (known as the “delta”) changes, and the defensive characteristics of the convertible bond readjust.

Given the dynamic characteristics of this asset class, an investment in convertibles requires a degree of analytical expertise that is not quickly or easily acquired. Additionally, the degree of diversification available through convertible funds cannot typically be matched by individuals buying convertibles for their investment portfolios. Individuals must be aware of inefficient markets and wide bid-ask spreads when buying relatively small amounts of individual convertibles.

**Conclusion**

Convertible bonds offer attractive investment characteristics in current market conditions – peak level equity prices combined with a 30-year bull market in bonds. The possibility of increased market volatility and a spike in interest rates is certainly plausible. Therefore, the asymmetric return characteristics, historical up-market and down-market capture ratios, and strong convertible liquidity through new issuance, all provide a compelling case for an investment in a diversified convertible bond fund.