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The convertible securities market takes off

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A surge in convertible issuance could change the landscape for this asset class.

How should investors think about the convertibles market?

Dave King: Convertibles are a way to pursue good risk-adjusted return through price appreciation and income. They complement traditional equity income allocations, offering some equity characteristics and some fixed-income characteristics. The casual observer may think that convertibles performance lands midway between the performance of stocks and bonds. But performance has been fairly consistent with the S&P 500 over the past 20 years — with lower volatility and more income. And it's been like that since the early 1970s, which is the beginning of any convertible index.

> A convertible security is either a bond or preferred stock offered by a corporation. It carries the option to be "converted" into a specific number of shares of common stock later.

David King, CFA, Senior Portfolio Manager, Head of Income and Growth Strategies

Why don't people use convertibles more?

Dave King: There are barriers to the asset class, and understanding the instrument is one. But certain types of bonds are just as complicated, and investors own them anyway. We also hadn't seen a lot of new issuance growth prior to this year. This is because companies have been able to issue bonds at such remarkably low coupons — even recent high-yield bonds are sometimes issued with a coupon in the 4% range. I think the small size of the market (about $200 billion) has kept it in the shadow of larger markets like high yield, the broader bond market — which has done great with falling interest rates — and stocks, which have also done well until recently.

How has the asset class performed this year?

Dave King: Year-to-date, we've seen this market bounce back to positive territory. It's a bit unexpected, given that the world is bouncing back from a very difficult market. Converts didn't fall as much as the S&P 500 and the indices have bounced back even stronger.

I think recent good performance is a bad reason to be attracted to an investment. But there's more interest in convertibles now, and it's a very underused asset class. For me, the most interesting detail about the asset class is the amount of new issuance: 2019 was a multi-year record, and we're on pace to have more new issuance through June than we had all of last year. The current pace would lead to a record year with over $100 billion in issuance.

Why is the surge in issuance significant?

Dave King: As I previously mentioned, there's been little growth in the asset class in terms of flows, which has driven down the number of convertible vehicles available to investors — there's a limited number of actively managed convertible mutual funds and fewer passive variants. That's a small selection for investors in a potentially attractive performance area. But if the volume of issuance continues, it could change the landscape for the asset class.

How does 2020 new issuance vary from what you have seen in prior years?

Dave King: It's important to understand the nature of the convertible universe prior to the pandemic. Pre-COVID-19, issuance was heavily weighted in growth areas and we often highlighted this as one of the more attractive benefits of the convertible market. Investors that are seeking growth and income investments tend to gravitate toward more value-oriented solutions — those that favor lower volatility and higher current yield.

Convertibles tend to be issued by more growth-type companies, yet they do have a lower volatility and higher income profile than a company's equity because of the nature of the security. This can be a benefit to investors looking to diversify away from value and looking for a lower volatility solution.

The nature of the issuance that we've had in the last two months has been heavily weighted toward a variety of more mature companies that wanted to raise cash because of COVID-19. Had you asked me on January 31 whether I would have anticipated large issues from areas like cruise lines, airlines or retailers, I would have said, "No, I don't anticipate that at all. Those industries aren't growing very fast. They're in solid shape. Why would they need new funding?"

What's been a boon to the asset class is that large household names, like Carnival Cruise Lines, Southwest Airlines and Dick's Sporting Goods, are now issuing convertibles. This is a rare opportunity to buy both secular and cyclical growth companies at the bottom of an economic cycle. But these companies are operating in a very challenging environment, so access to in-depth equity and fixed-income research is critical to understanding whether they merit investment.

What does it mean for investors?

Dave King: I believe many of these new issues provide an opportunity for investors who previously didn't own convertibles to navigate the recovery of the U.S. economy in a more defensive way — using instruments that are higher in the capital structure than common stocks. It is an interesting proposition for an investor looking for a combination of growth and income. Combine this with the risk of dividend cuts on the common stock, and convertibles appear even more attractive. It's possible that convertibles could become all-weather investments in a portfolio.

The convertible market is growing. It's been in the neighborhood of $185 billion to $220 billion for a decade. Now it's suddenly $270 billion. History would suggest that it will hit another plateau — more than likely in the vicinity of $400 billion — which puts it at approximately 40% of the size of the high-yield market (the convertible market and the high-yield market were roughly the same size 25 years ago). In the long run, market cycles and sizes of assets do change. It's hard to tell whether this is just a tremor or a full-blown expansion, but I think we'll have very robust issuance for some time. And we believe that more issuance will work to the benefit of investors.

Disclosures

The S&P 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. It is not possible to invest directly in an index. Securities referenced are for illustrative purposes only and should not be constructed as a recommendation to buy, sell or hold.

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