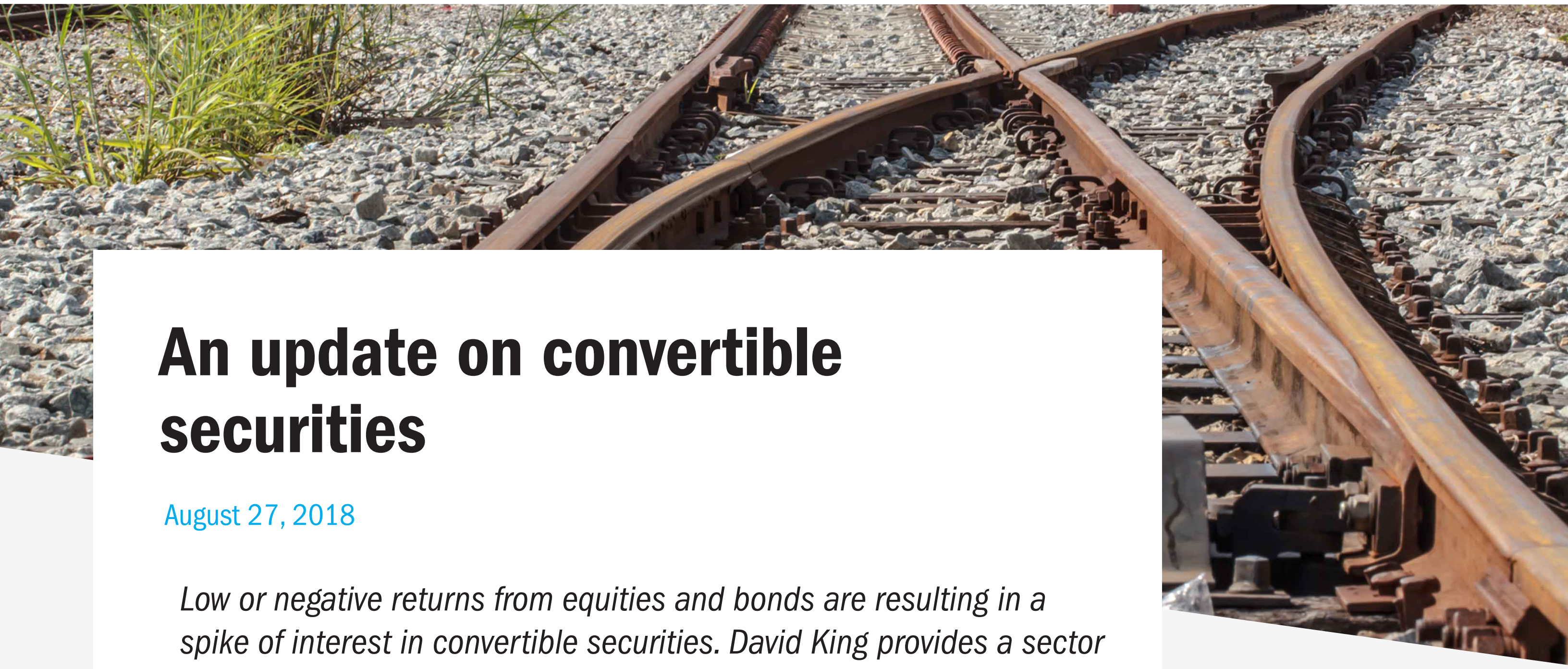

An update on convertible securities

August 27, 2018

Low or negative returns from equities and bonds are resulting in a spike of interest in convertible securities. David King provides a sector update.

David King, CFA
Senior Portfolio Manager

Q: What do you tell investors who've never looked at convertible securities before?

David: Investors assume the performance and risk of convertible securities is somewhere in the middle of bonds and stocks. But over the last 20 years, convertible securities have performed a bit better than the S&P 500 Index with less volatility and more yield. I always start the discussion there, and the reaction is usually surprise at how well the category has performed over time.

Convertible securities are bonds or preferred stocks that can be converted into shares of common stock.

I'd say a secondary reaction is that people view convertible securities as an asset class that you need to trade in and out of, and they want advice on when to invest in convertible securities. They've ignored this asset class in the past because of concerns about making a wrong decision on when to invest in or move out of it. My suggestion is rather than focus on timing, consider treating convertible securities like a long-term investment as you would equities or bonds.

Q: What is the profile of your typical fixed-income investor?

David: The most common scenario is investors who have made a lot of money over the last 30-plus years in bonds and have assumed they'll continue to do so. Lately, they're totally disoriented because they were in a fixed-income bull market for a long time and are starting to see really low or negative returns from their fixed-income portfolio and aren't sure where to turn. They're looking for something that works when bonds don't.

To that investor we point out the historical tendency for convertibles to do well in a rising interest rate environment. Secondarily, convertibles are typically short duration bonds, which makes them a defensive replacement for longer duration bonds when rates rise. On top of all that, rising interest rates are normally a sign of good economic growth, so the equity component of convertible securities can provide an additional boost to performance.

Q: What type of equity investors are usually interested in convertible securities?

David: Typically, this is an investor who is somewhat conservative by disposition and age (50s or 60s), who needs equity exposure for their money to grow through retirement but want lower volatility. With his profile, their portfolios are usually dominated by investment options that have many characteristics of value strategies like dividend income funds or utility stocks. There is no way that I know of to duplicate a higher income, lower volatility profile and still be exposed to growth stocks, other than in convertible securities. Convertible securities are typically issued by growth-oriented sectors like technology, biotech and cyclical industries. As a result, the diversification benefit to owning convertible securities when the rest of your assets are value, or income-oriented, is quite significant.

Q: Growth stocks have outperformed value stocks for a long time. What does it mean for convertibles if that trend reverses?

David: Within equities, convertible securities have historically had the strongest correlations to the Russell Midcap Growth Index. The outperformance of growth stocks has been driven by the inclusion of five or six mega-cap stocks. I'd argue that if you remove those mega-cap stocks the outperformance of growth has been shorter lived, so the risk of a reversion to the mean isn't as significant. The types of companies that issue convertible securities don't have a lot in common with these mega-cap stocks. They aren't that big or well-financed. Growth companies that issue convertible securities tend to be smaller companies that need a quicker, easier and cheaper way of issuing common stock or bonds.

Q: Are you concerned about the low issuance of convertible securities?

David: No. There's been a lack of issuance, but recently that has begun to change. The dollar value of convertible securities issued up to this point in 2018 is greater than all of last year. In fact, issuance is higher now than either of the prior two years. It's difficult to make predictions for the convertibles market because about 25% renews each year. Issues convert, mature or are restructured. But from a macro perspective, most forces suggest issuance will continue to increase, especially if interest rates go up (making it more expensive for firms to issue bonds) and the outlook for the stock market continues to be good (allowing issuers to sell common stock indirectly at a price higher than the current price).

If interest rates go higher I think the blend of issuers will tilt more to the old economy. When I say "old economy" I'm referring to companies in mature businesses that grow in line with the broader economy. I'm not referring to fast-growth companies, like a company that would have sudden, incredible growth if a cancer drug trial goes well.

Q: Is it possible to maintain diversification in a convertible securities portfolio today?

David: Yes, as long as the issuance stays diversified across sectors like utilities, industrial, mature pharmacy and consumer discretionary, we're okay. The difference between being just okay and great would be if we start to see issuance from additional sectors like food, materials and telecom. But we can maintain good diversification with the issuance we're seeing. A warning sign would be if all the issuance was from a single sector, because that's a signal that something is unbalanced in the economy. In the late 1990s most issuers were cellular or internet-based, which was a warning sign for the dot.com bubble, and in 2008 the issuers were predominantly banks, which was a warning sign for the financial crisis. That isn't the case today.

Q: How has tax reform affected this market?

David: I think it has been a minor positive. It is a little more favorable for domestic stocks, and convertibles are a little more domestic than other markets. There's also an obscure part of the new tax code that could help convertibles by limiting interest deductibility for highly levered companies. The high-yield bond market is over $1 trillion in size, and the convertible securities market is a fraction of that at $230 billion. I think of it like a water balloon, where the balloon is high-yield and the little part by the knot is the convertibles market — if you squeeze the balloon the water shifts and the part by the knot expands. Anything that puts a little pressure on the larger high-yield market could have a large positive effect on the size of the convertibles market.

Q: How do convertible securities trade?

David: The convertible securities market isn't like the stock market with transparent pricing and low execution costs; it's an over-the-counter market like before Nasdaq existed. To buy or sell convertible securities, you need to work with large brokers and trade securities based on bid-ask prices. Individual investors will find that a large portion of the convertible securities market is unavailable to them, and for the rest they can't see the actual price. If you try to do it yourself, trading challenges can translate into percentage points lost per year due to higher trading costs. Having the skillset to analyze and trade convertible securities, and then having access and transparency to the market, are two different things.

Bottom line

Interest in convertible securities is increasing. Convertible securities may be a good fit for fixed-income investors looking to diversify away from bonds and equity investors who need to maintain growth with lower volatility.

The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization U.S. stocks. The Russell Midcap Growth Index measures the performance of those Russell Midcap companies with higher price-to-book ratios and higher forecasted growth values. The stocks are also members of the Russell 1000 Growth index. It is not possible to invest directly in an index.

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