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Investment Insights:

Convertibles Resume their Historic Strategic Role

In a Rising Interest Rate Environment, Convertibles Offer Lower-Risk Equity and Higher-Returning Fixed Income Exposure

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March 2018 marked the ninth anniversary of the current bull market which is now the second longest and second strongest in US history. Investors who wish to participate in some future equity gains yet lower their downside equity risk may be considering low-volatility equity indices, created purportedly for this purpose. We believe that investors would be well served to consider convertibles instead. In two significant equity market pullbacks in 2018, convertibles held up better than low volatility equity indices.

In mid-June, the Dow had eight consecutive losing days, the longest streak of losses in almost 40 years, and was on track to break through its 200-day moving average for the first time in two years. Thankfully, the market regained its footing on June 22. It avoided a replay of the late January through early February correction, which saw the Dow plummet more than 3,200 points, or 12%, including two 1,000-point plunges.

What surprised many investors about the January to February period was that traditional equity safe havens—large-cap stocks and low volatility equity index strategies—were hit the hardest.

As you can see in Exhibit 1, below, the MSCI USA Min Vol Index was down slightly more than the broad market S&P 500, -9.17% vs. -9.03%. Convertibles, in contrast, were among the best performers. The B/A ML All Quality Index was down -5.42% and the TR US All Cap Convertibles, which represents more "balanced" and less equity-sensitive issues, was down -4.24%. For the full month of February and full first quarter, Convertibles were positive whereas equities were flat to negative.

KEY TAKEAWAYS

- Convertibles are more attractively valued than low volatility equity indexes
- Convertibles have less interest rate risk than straight bonds
- Record new issuance creates more opportunity for "balanced" managers
- SMID issues dominate, creating exploitable inefficiencies

Exhibit 1: Convertibles Outperformed Equities During Recent Correction

PERFORMANCE (%)	1/26/2018–2/8/2018*	FEB 2018	1Q 2018
MSCI USA Min Vol Index (USMV)	-9.17	-3.90	-0.59
MSCI USA Index	-10.08	-3.67	-0.63
S&P 500	-9.03	-3.69	-0.76
Russell 2000	-8.57	-3.87	-0.08
B/A ML All Quality Convertible	-5.42	-1.16	2.40
TR US All Cap Convertibles	-4.24	-0.75	2.36

Source: FactSet, Nicholas Investment Partners.
**Calculated using the change in end of day price for each index or ETF. ETF proxy was used for the MSCI USA Min Vol Index. Results may vary for different time periods.*

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What accounted for convertibles outperforming and low volatility indexes underperforming? We believe two critical factors were higher interest rate risk and higher valuations.

Low volatility indexes have substantial interest rate risk. The MSCI USA Min Vol Index is weighted heavily to bond proxies with more than 25% of the Index in Consumer Staples, Utilities and Real Estate. During the late January to early February downdraft, the 10-year Treasury yield jumped to a 4-year high of 2.95%. Over the same time period, the MSCI USA Min Vol Index pulled back -9.17% and the interest rate sensitive, bond proxy sectors posted negative returns.

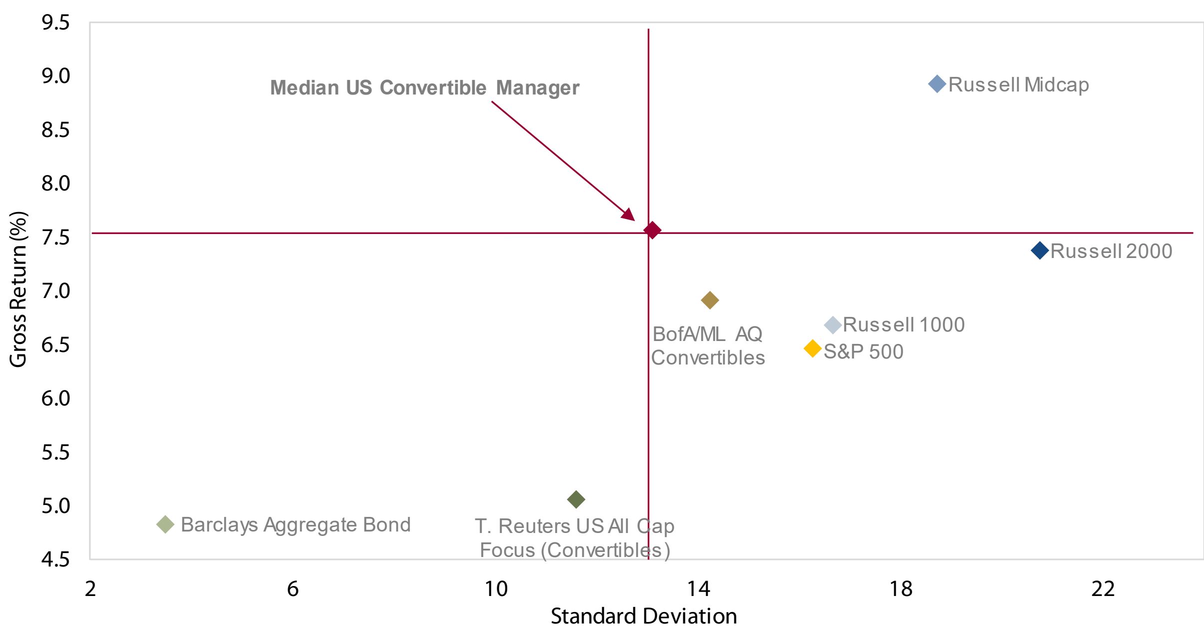
In contrast, the B/A ML AQ Convertible Index had only a 12% weight to these three sectors. The largest sector in convertible indices is typically Information Technology, with over a 33% weighting. It was the only sector with positive returns in February.

In addition, the valuations of low volatility indices are unattractive today, especially given the low growth prospects of many of its constituent companies. The MSCI USA Min Vol Index value is near its historic high with a P/E (FY1/FY2) of 18.42x and P/B of 3.53x, both at premiums to the lower growth rate of 17.5%.

We believe the underlying equity characteristics of convertibles are a more attractively priced and may be a better way to get low volatility equity exposure. The B/A ML AQ Convertible Index's P/E (FY1/FY2) is 14.12x, 23% lower, and P/B is 1.93x, 45% less, compared to the MSCI USA Min Vol Index.

Convertibles hybrid structure offer equity participation with a built-in shock absorber through the security's preferred dividend or coupon, which is typically higher than the yield of underlying equity. Investors get paid to wait for the underlying equity optionality to pay off. They also benefit from being more senior to equities in the underlying issuer's capital structure. These features have contributed to convertibles historically generating compelling risk-adjusted returns versus equities over the last 20 years, as shown in Exhibit 2.

Exhibit 2: Convertibles Offer an Attractive Risk/Reward Profile (20 Years Ending 3/31/2018)



Index	Rate of Return	Standard Deviation	Upside Mkt Capture	Downside Mkt Capture	Sharpe Ratio	Correlation Thompson Reuters US All Cap Focus	Correlation BofA/ML AQ Convertibles
Barclays Aggregate Bond	4.83	3.48	12.18	-31.02	0.83	-0.36	-0.35
T. Reuters US All Cap Focus (Convertibles)	5.05	11.60	65.56	65.19	0.27	1.00	0.94
BofA/ML AQ Convertibles	6.91	14.26	82.05	72.47	0.35	0.94	1.00
Russell 1000	6.68	16.69	102.70	101.53	0.28	0.91	0.89
Russell MidCap	8.93	18.73	117.33	101.37	0.37	0.90	0.90
Russell 2000	7.37	20.78	117.88	113.96	0.26	0.86	0.83
S&P 500	6.46	16.29	100.00	100.00	0.28	0.90	0.88

Source: eVestment, Nicholas Investment Partners.

Convertibles Are an Alternative to Traditional Fixed Income in a Rising Interest Rate Environment

While the spike in interest rates prompted a short-term price correction in stocks in February, it likely signaled a more profound regime change potentially leading to the longer-term underperformance of bonds. The 35-year bull market in bonds propelled by falling interest rates seems to be at or near its end.

According to a Bank of America Merrill Lynch Fund Manager Survey, fund managers have cut their bond allocations to the lowest level since the inception of the survey in 1998, with a net 69% underweight to fixed income. Convertibles, a shorter duration security, may offer an attractive alternative to traditional fixed income, which tend to underperform in rising interest rate environments.

Several features of convertibles contribute to their lower interest rate risk. Convertibles typically have less duration risk, with an average duration of less than 5 years. In addition, the equity optionality often becomes more valuable as corporate profits rise during an economic expansion, which is typically when interest rates rise.

As interest rates rose in the first quarter, convertible and convertible arbitrage strategies outperformed the Barclays Aggregate Bond Index (Exhibit 3). (Convertible arbitrage strategies are those in which the underlying equity exposure is hedged.)

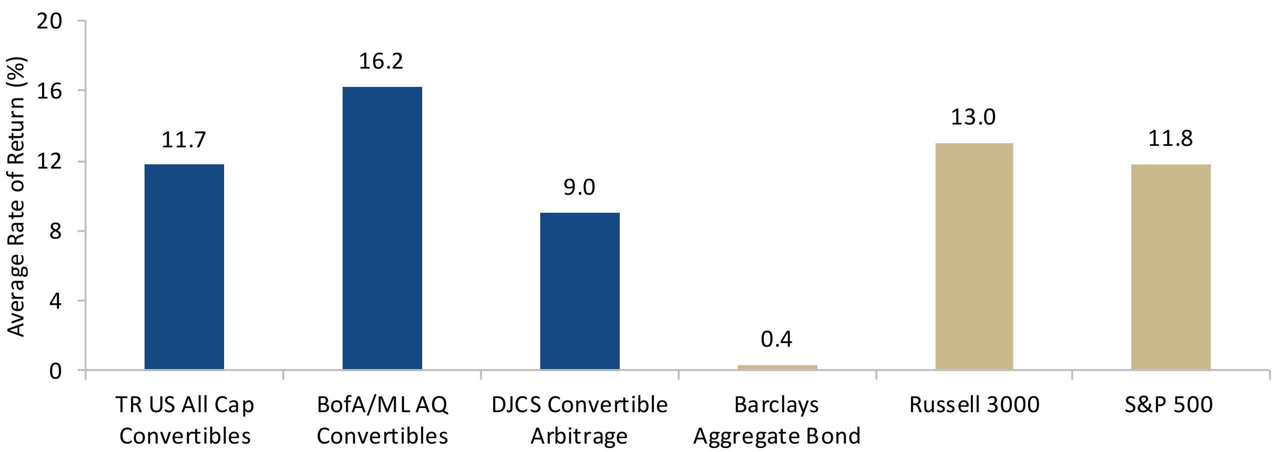
Exhibit 3: Convertibles and Convertible Arbitrage Outperformed Bonds as Interest Rates Rose

PERFORMANCE (%)	1Q 2018
TR US All Cap Convertibles	2.36
B/A ML All Quality Convertible	2.40
DJCS Convertible Arbitrage	0.84
Barclays Aggregate Bond	-1.46

Source: FactSet, Nicholas Investment Partners. Results may vary for different time periods.

This confirms the historic trend we've been tracking since the early 1990s. A study of the last seven periods when 10-Year Treasury yields rose more than 100 bps demonstrates that convertibles and convertible arbitrage strategies have historically delivered compelling returns, whereas traditional bond returns were either flat to negative:

Exhibit 4: Average Performance During Last Seven Largest Interest-Rate Increases



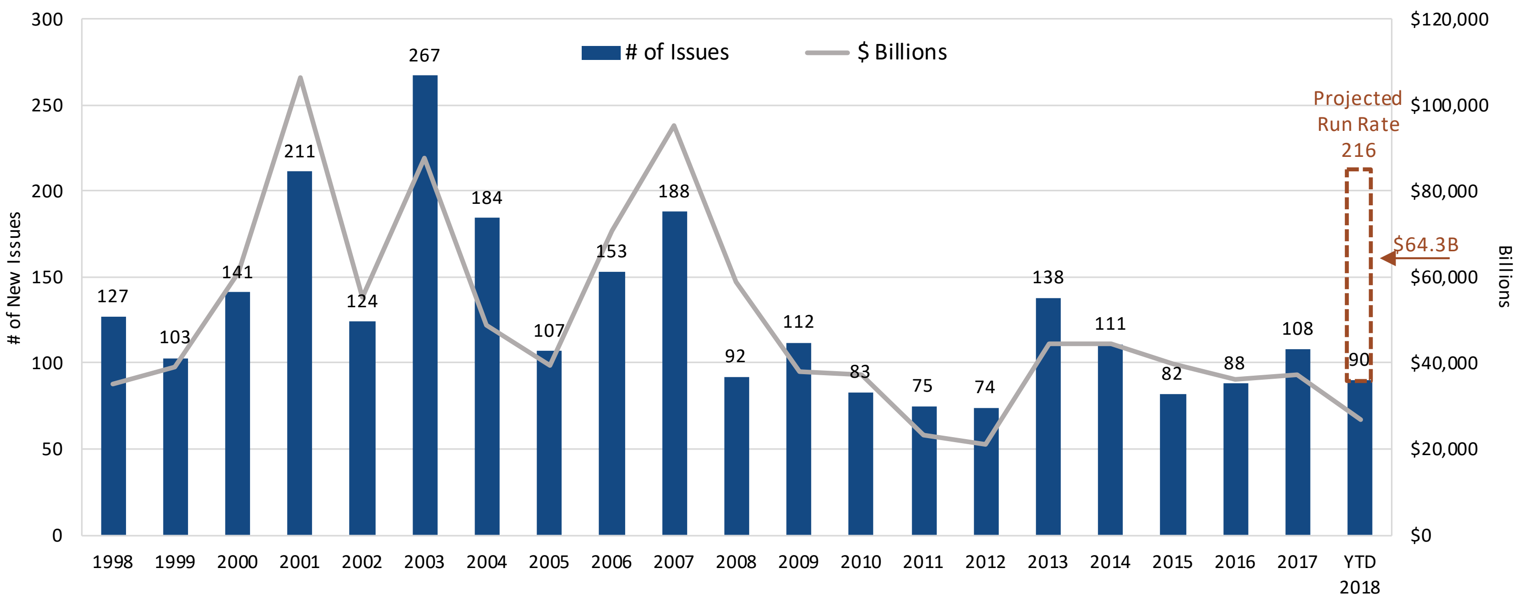
Source: FactSet, eVestment, Nicholas Investment Partners. The graph above illustrates the arithmetic average return of cumulative performance of each index over seven periods of rising interest rates using the US 10 Year Treasury yield for the following periods: 12/31/1995–6/30/1996; 9/30/1998–1/31/2000; 10/31/2001–4/30/2002; 5/31/2003–6/30/2004; 5/31/2005–6/30/2006, 11/30/2008–6/30/2009 and 9/30/2010–12/31/2010. Results may vary for different time periods.

Record Convertible Issuance Creating More Opportunity

The sweet spot of convertibles in which we invest in both our long-only and convertible arbitrage portfolios are those we expect to offer 60 to 70% of the upside of the underlying equity with only 30 to 40% of the downside. These “balanced” securities had been an increasingly smaller part of the convertible universe with a dearth of new issuance. Record low interest rates over the last five years resulted in companies being able to issue straight high yield debt cheaply. This led to the convertible market becoming increasingly dominated by more equity-sensitive convertibles.

2018 marked a dramatic reversal of this trend. New issuance picked up due to three factors: the rise in rates made straight debt more expensive; the new tax bill’s cap on interest expense; and an unwillingness to dilute existing shareholders by issuing more equity. As a result, convertible issuance is now on track to hit a 10-year record of over $60B at its current run-rate as shown in Exhibit 5.

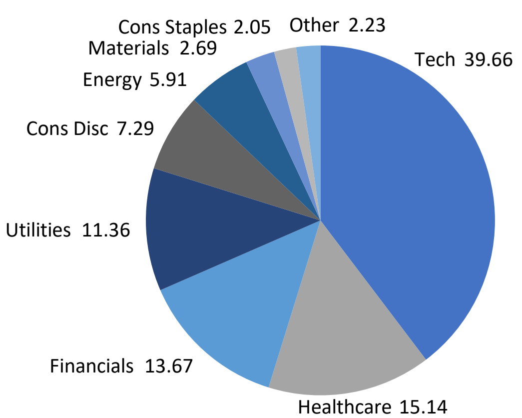
Exhibit 5: Convertible New Issuance



As of 5/31/2018. Source: BofA/Merrill Lynch Global Convertibles Chartbook.

These new convertible issues are increasingly being offered in innovative sectors and industries that have more growth potential and supportive secular tailwinds, such as software, pharmaceuticals, technology and media companies (Exhibit 6).

Exhibit 6: Convertible New Issuance by Sector (%)



As of 5/31/2018. Source: BofA/Merrill Lynch Global Convertibles Chartbook.

The inefficiencies of the convertible market make it attractive for active managers, especially those like us whose expertise combines small- to mid-cap growth equity insights with traditional credit analysis. For example, 69% of convertible issues are small-cap companies with another 23% in the mid-cap range. Over 50% of issuers are not rated, including 89% of new issues, so original research is critical to evaluating these investment opportunities.

Another key feature in new issuance is the average issue size is well under $500M. Thus, we are able to use our small relative size of approximately $400M+ in notional exposure to our advantage.

In summary, it was gratifying to see convertibles add value relative to both stocks and bonds in the first quarter of 2018. They provided their historical downside protection during the equity market correction as well as the bond market’s rout. We look forward to the second half of the year as record new issuance creates even more opportunity to add value for our clients who are using our convertibles strategies as lower-risk equity or a higher-return fixed income substitutes in a rising interest rate environment.

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- Our edge comes from combining fundamental equity and credit research with the objectivity and efficiency of quantitative analytics. We have a results-driven and client-centric culture centered on building lasting and value-added relationships with a select group of institutional and private wealth clients and consultants.

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