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# Holding the middle ground with convertible securities

*Convertible securities offer a combination of growth and income that may be attractive to many investors.*

*Over the past decade, these hybrid securities have performed competitively with stocks, while generating more income.*

*The convertibles market is diverse, ranging from niche micro-cap businesses to better-known large-cap names.*

## **Tapping into the benefits of stocks and bonds**

An investor's need for either current income or the potential for capital appreciation naturally dictates a preference for bonds or stocks. However, many investors seek both objectives. Convertible securities can tap into the best of both worlds. Historically, these securities have a record of providing attractive risk-adjusted returns. They can also add portfolio diversification in terms of sector, style, and market capitalization.

Convertibles are not new to Wall Street, having helped finance growing industries for more than a century. Over time, the convertible securities market has grown in size and in its array of offerings. Today, convertibles represent an asset class that is unique, vibrant, and often inefficient. Experienced investors have come to understand that these unique instruments can supplement their income while providing the potential for capital appreciation. Yet, convertibles remain a mystery to many investors. We have written this survey to help investors understand the attractive features of this overlooked asset class.

## Fundamental properties

Convertible securities are hybrid instruments: They are typically issued as bonds or preferred stock while offering investors the ability to “convert” to a specific number of shares of common stock. This hybrid nature affords investors a unique opportunity. First, convertible investors benefit from both the income and downside protection offered by the convertible’s fixed income characteristics. This benefit eludes investors in common stock. At the same time, convertible investors can profit from the potential price appreciation of the issuer’s underlying common stock. This benefit eludes investors who own typical corporate bonds.

Not all convertibles function in the same manner.

**Convertible bonds** more closely mirror traditional bonds, offering income via coupon payments (which are contractual obligations of the issuer), along with a stated maturity date on which the issuer is obligated to repay the principal amount. This bond-like characteristic of the instrument provides the investor with downside protection. In addition, there is also an embedded call option on the underlying stock, through which an investor is able to participate in equity upside.

**Convertible preferred stocks** offer income in the form of fixed dividend payments. These instruments are typically subordinate in the issuer’s capital structure to traditional debt, and sometimes have no maturity; therefore, they generally provide less downside protection than do convertible bonds. However, convertible preferred stocks generally provide higher dividend payments than convertible bonds. This characteristic serves to compensate for the lower level of downside protection. Convertible preferred stocks also contain a similar embedded call option on the underlying stock, and therefore participate in equity upside, often to a greater degree than convertible bonds.

A third kind of convertible — **mandatory convertibles** — typically offers a higher yield than both convertible bonds and preferreds. This higher yield principally compensates for the added wrinkle of investors receiving stock with no option to be paid cash if they hold these instruments until maturity.

All three types of these hybrid instruments have come to represent an increasingly popular method of financing, allowing the issuing companies to raise capital at relatively low cost.

## Today’s convertibles market

The convertibles market provides access to capital for a wide variety of companies. Convertibles have become particularly beneficial to small and midsize companies whose low credit ratings, limited earnings history, or small market cap may limit their ability to access the straight equity or debt markets at levels attractive to them. The market also has become increasingly attractive to investment-grade companies, given the relatively low cost of capital associated with issuing convertibles and the diversification of funding sources that convertibles provide. From a capitalization perspective, there has been great interest in recent years from small- and mid-cap companies, but we have also seen a number of high-profile large-cap companies access the convertibles market as well (Figure 1).

The use of proceeds from new issuance has also been fairly varied. With the relatively low-interest-rate environment of the past several years, we’ve seen companies raise funds for refinancing purposes, and more recently, more aggressively for merger-and-acquisition activity as well as share buyback activity to support stock prices. Increased issuance has created more diverse investment opportunities, which has benefited the broader convertibles market.

FIGURE 1

## The convertibles market in 2018

ICE BofAML U.S. Convertible Index

Total market size	\$170.7B
Average market yield	2.75%
Average conversion premium	\$52.39
Large cap (\$10B+)	42.08%
Mid cap (\$2-\$10B)	36.84%
Small cap (\$0-\$2B)	21.09%

Source: ICE BofAML, as of 12/31/18.

## Distinctive opportunities

The inefficiencies in the convertibles asset class provide a myriad of investment opportunities, which Putnam's convertibles team specifically focuses on uncovering and exploiting. Included in this opportunity set are situations in which some investors periodically overreact to negative fundamental developments and market dislocations, selling convertible positions prematurely. This kind of selling exerts even greater downward pressure on prices, creating value opportunities for investors with a more long-term, fundamental approach to the market.

High-yield convertibles represent a uniquely attractive, and typically less efficient, subset of the convertible securities market, and offer a significant opportunity for experienced investors. Some issues start out with yields above that of the market as compensation for a greater degree of credit risk at the issuer or, in the case of "mandatories," as compensation for the mandatory conversion feature. Other convertible securities become higher yielding due to deterioration (real or perceived) in the fundamentals of the issuer, as is the case with "busted" convertibles and "fallen angels" (defined on the right).

Whether or not they originate as high-yield convertibles, these securities offer yields that are typically higher than common-stock dividend yields. What's more, they have demonstrated limited correlation to other major equity and bond indexes in recent years, making them attractive from a diversification standpoint. The success of these investments generally is not contingent on appreciation in the underlying stock price; the yield is often high enough that these investments generate attractive returns even in the absence of stock price appreciation.

Diversification does not guarantee a profit or ensure against loss. It is possible to lose money in a diversified portfolio.

## Higher yielding opportunities

### Fallen angels

Convertible bonds that were once rated investment grade but that have since been downgraded to a rating below BBB.

### Rescue financing

Convertible debt issued to aid financially distressed companies.

### Mandatories

Convertibles that do not offer cash at maturity. If the owner of a mandatory convertible holds the security until maturity, he or she will receive common stock on the maturity date.

### Busted convertibles

A convertible whose underlying stock is trading well below the conversion price on the embedded call option (also referred to as being deeply "out of the money"). These securities become much less sensitive to moves in the underlying stock, responding instead to changes in the company's credit quality. Analysis of these types of investments focuses more on underlying asset value and cash flow generation than on earnings growth and other traditional equity metrics. The objective of buying a busted convertible is to take advantage of an overreaction to negative fundamental developments at the company, and/or an underappreciation by the market of the company's ability to eventually turn around.

## Advantages for investors

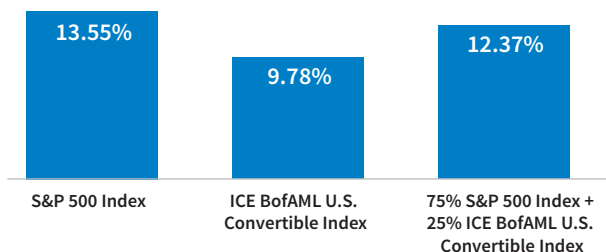
We believe convertible securities offer five main advantages to investors:

**1. Diversification** For many investors, managing portfolio risk means limiting volatility. Convertible securities offer a unique way to accomplish this over long time horizons. In a falling stock market, the debt portion of the convertible typically cushions the effects of a market decline, often allowing convertibles to outperform equities. In a rising stock market, convertibles may also provide the opportunity for capital growth, albeit to a lesser degree than common stock. In volatile markets, such as the one experienced in 2007 and 2008, the underlying call options embedded in convertible securities tend to rise in value, adding to the price of convertible securities.

It is important to point out that although convertible investors do not typically participate in 100% of the movements in the underlying stock, historically they have generally participated in a greater proportion of upward movements than downward movements (absent meaningful credit deterioration) because of the downside protection provided by the instrument’s debt characteristics (Figure 5). Adding convertible securities to an all-equity portfolio reduced portfolio standard deviation over the past 10 years (Figure 2).

FIGURE 2

Adding convertibles has lowered volatility (standard deviation, 12/08–12/18)



Source: Putnam research, 2018. Index performance is not indicative of Putnam fund performance. Past performance is not indicative of future results. You cannot invest in an index.

Convertibles also offer diversification along the lines of industry, style, and market capitalization. Equity income funds — a typical alternative to convertibles — generally have high concentrations in industries such as financials and utilities, and are often more heavily weighted toward larger-cap, value-oriented stocks. The breadth of the convertibles market provides investors with an opportunity to participate in a wider variety of sectors that span the entire capitalization spectrum through both growth and value stocks.

**2. Income potential** Compared with traditional equity securities, convertibles have provided the opportunity for superior income potential (Figure 3). Also, unlike equity dividends, the convertible coupon (or dividend) is contractually guaranteed, providing investors with a more secure income stream. In select cases, convertible mutual funds may look to enhance income by purchasing higher yielding convertible structures, such as mandatories, busted convertibles, preferreds, and rescue financing.

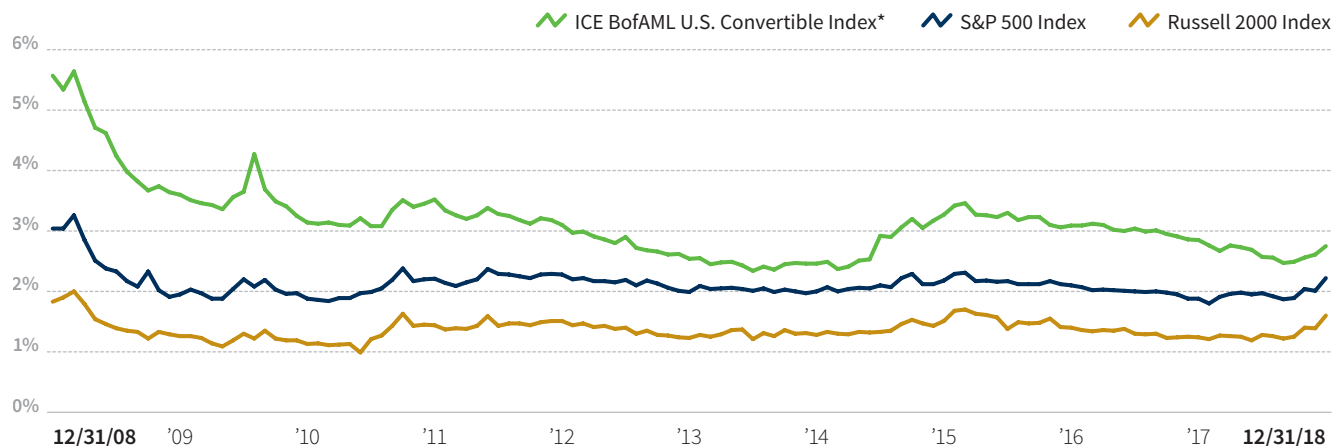
**3. Opportunity for capital appreciation** While a convertible’s fixed income characteristics can mitigate downside risk if the issuing company’s common stock performs poorly, the underlying equity option allows the holder to participate in a portion of the upside if the stock performs well. As a result, convertibles offer the potential for attractive risk-adjusted returns. Indeed, the performance of convertibles has been remarkably strong, generally keeping pace with the performance of common stocks over the past 10 years (Figure 4).

**4. Lower principal risk** Convertibles generally represent a lower level of principal risk than common stock since convertibles are more senior in the capital structure. In the event of corporate bankruptcy, convertible holders are repaid ahead of common shareholders.

**5. Lower interest-rate sensitivity** The hybrid nature of convertible securities causes them to have lower duration — or interest-rate sensitivity — than pure debt instruments. Features that allow convertibles to participate in the equity upside potential of the underlying common stock, for example, can reduce their interest-rate sensitivity. As a result, convertible securities have been less influenced by interest-rate movements than bonds, and have performed well in rising-rate markets.

FIGURE 3

## Convertibles have provided higher yields than stocks (dividend yields, 12/31/08–12/31/18)

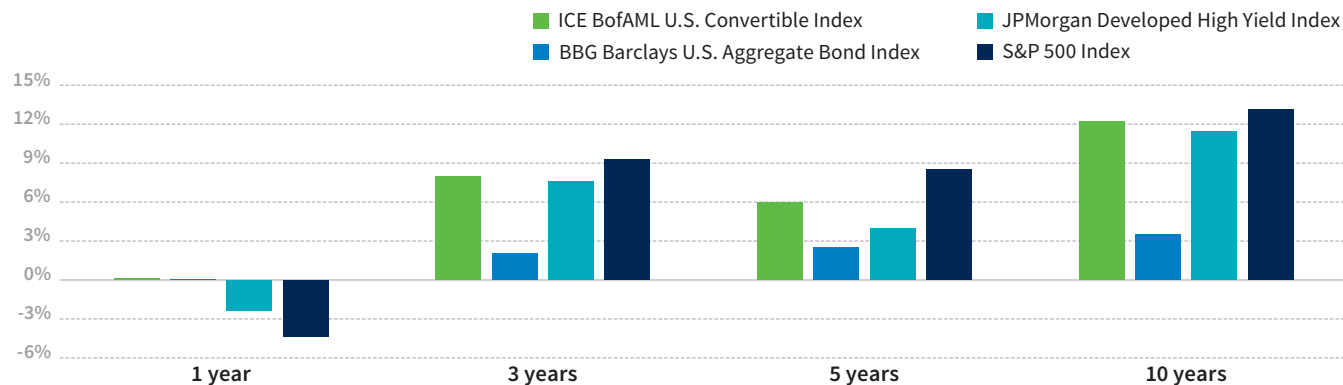


\* Current yield.

Sources: ICE BofAML, S&P Dow Jones Indices, Frank Russell Company, Putnam Research, 2018. Index performance is not indicative of Putnam fund performance or a guarantee of future results. You cannot invest in an index.

FIGURE 4

## Convertibles can provide diversification in a portfolio (annualized asset class returns as of 12/31/18)



	ICE BofAML U.S. Convertible	BBG Barclays U.S. Aggregate	JPMorgan Developed High Yield	S&P 500
<b>Correlation (5-year)</b>				
ICE BofAML U.S. Convertible	—	0.04	0.75	0.85
<b>Risk (5-year)</b>				
Sharpe ratio	0.65	0.70	0.66	0.73
Standard deviation	8.22%	2.77%	5.11%	10.85%

Source: Putnam research, 2018. Index performance is not indicative of Putnam fund performance or a guarantee of future results. You cannot invest in an index.

Sharpe ratio is a measure of historical adjusted performance calculated by dividing the fund's return minus the risk-free rate (FTSE 30-day Treasury Bill Index) by the standard deviation of the fund's return. The higher the ratio, the better the fund's return per unit of risk. Standard deviation measures how widely a set of values varies from the mean. It is a historical measure of the variability of return earned by an investment portfolio.

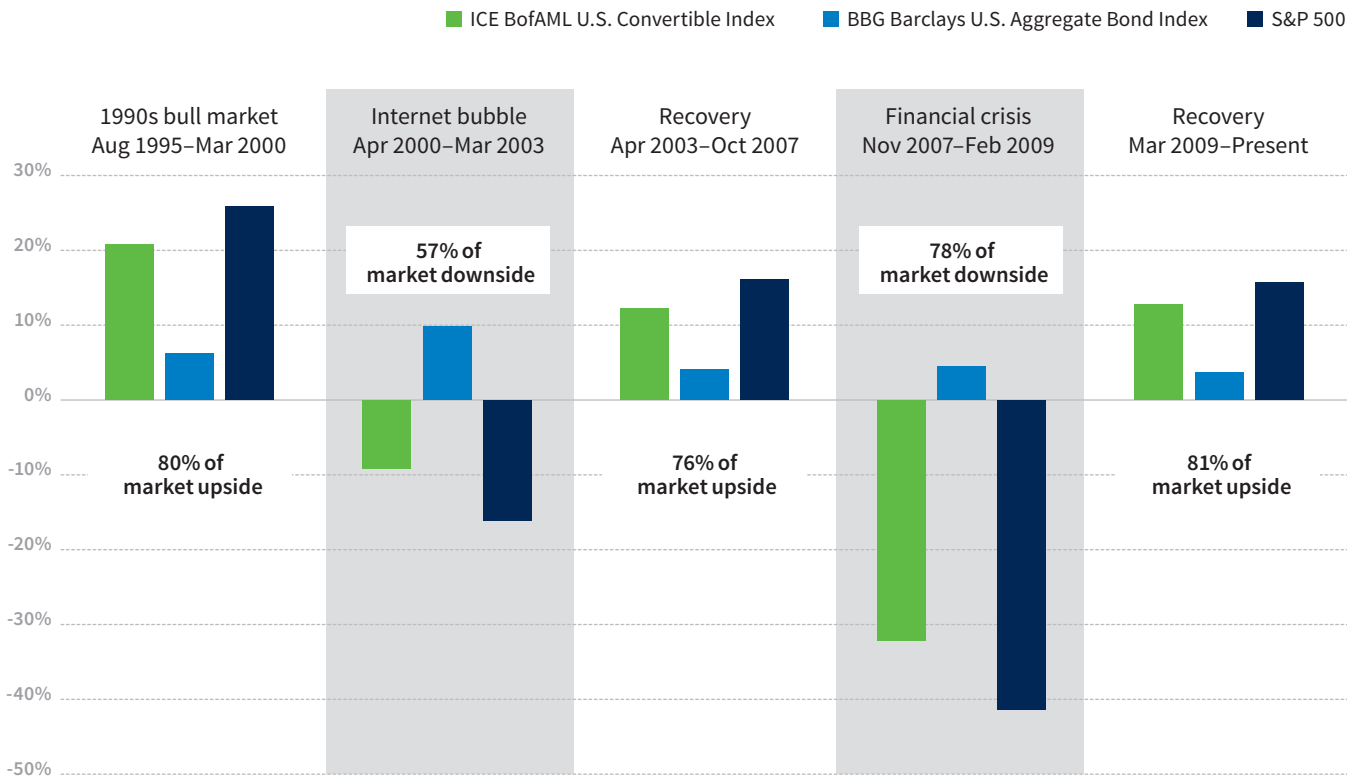
### The Putnam difference

In our view, active management is vital. Properly evaluating a convertible security requires a combination of equity, fixed income, and structural analysis, all of which require experience, time, and resources. For these reasons, using a professional money manager is often the best option for investing in this market. For individuals looking to take advantage of convertible opportunities, Putnam’s convertible portfolios allow investors to leverage some of the best minds, experience, and results in the actively managed convertibles market.

At Putnam, our strength in managing convertibles for more than 45 years comes from our extensive experience, the vast internal resources we draw upon, and our disciplined, holistic approach to analyzing convertible opportunities. Robert Salvin, with more than 32 years of experience, specializes in analyzing convertibles from a fixed-income perspective. Anthony Daigle, with 14 years of experience, specializes in analyzing convertibles from an equity perspective. This holistic approach to analyzing the many facets of convertible securities permeates our portfolio team of analysts and traders, which operates with the focus and dedication of a boutique firm within one of the world’s best-resourced investment companies.

FIGURE 5

## Convertibles may offer upside potential with downside protection (7/31/95–12/31/18)



Source: Putnam, as of 12/31/18. All returns are annualized. Index performance is not indicative of Putnam fund performance or a guarantee of future results. You cannot invest in an index.

As portfolio managers, we are able to leverage the substantial resources of Putnam’s global equity and credit research analysts. Our goal is to determine the true worth of an issuing company’s business using both equity and credit analysis, as well as to assign an intrinsic value to the convertible itself based on quantitative methods. Once we have identified opportunities, the team is able to take advantage of the dedicated services of our traders. In an inefficient market such as convertibles, trading experience can be an offensive tool.

The collective efforts of our team combine to offer investors a “pure” convertible portfolio (very few common stocks or straight corporate bonds). That is, we take a long-term perspective that seeks to capture the dual benefits of the convertible structure: capital preservation and reduced volatility from the bond component, and upside opportunity from the equity conversion option.

*Topics presented in this paper are not necessarily applicable to funds managed by the authors, which may employ strategies not covered here. See the fund’s prospectus for details.*

*The opinions expressed here are those of Robert L. Salvin and Anthony J. Daigle are not intended as investment advice. They are also subject to change with changing market conditions.*

*The ICE BofAML U.S. Convertible Index represents convertible securities spanning all corporate sectors and having a par amount outstanding of \$25 million or over. Maturities must be at least one year. The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index of U.S. investment-grade fixed-income securities. The JPMorgan Developed High Yield Index is an unmanaged index of high-yield fixed-income securities issued in developed countries. The FTSE 30-day T-Bill Index is an unmanaged index that measures the rate of return for 30-day U.S. Treasury bills. The S&P 500 Index is an unmanaged index of common stock performance. You cannot invest directly in an index. The ICE BofAML U.S. Convertible Index is an unmanaged index of high-yield U.S. convertible securities. The Russell 2000 Index is an unmanaged list of common stocks that is frequently used as a general performance measure of U.S. stocks of small and/or midsize companies.*

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**Consider these risks before investing in a convertible income fund:** Convertible securities prices may fall or fail to rise over time for several reasons, including both general financial market conditions and factors related to a specific company issuer or industry. These risks are generally greater for convertible securities issued by small and/or midsize companies. Convertible securities' prices may be adversely affected by underlying common stock price changes. While convertible securities tend to provide higher yields than common stocks, the higher yield may not protect against the risk of loss or mitigate any loss associated with a

convertible security's price decline. Convertible securities are subject to credit risk, which is the risk that an issuer of the fund's investments may default on payment of interest or principal. Credit risk is greater for below-investment-grade convertible securities. Convertible securities may be less sensitive to interest-rate changes than non-convertible bonds because of their structural features (e.g., convertibility, "put" features). Interest-rate risk is generally greater, however, for longer-term bonds and convertible securities whose underlying stock price has fallen significantly below the conversion price. You can lose money by investing in the fund.

**A world of investing.®**



**Request a prospectus, a summary prospectus if available, or an offering statement from your financial advisor or by calling Putnam at 1-800-225-1581. The prospectus and offering statement include investment objectives, risks, fees, expenses, and other information about the funds that you should read and consider carefully before investing.**