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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 convertible 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, mandatories, or preferred stock while offering investors exposure to the underlying equity of the security. This hybrid nature affords investors a unique opportunity. First, convertible investors may benefit from both income and the potential mitigation of downside risk sought through 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**, which represent ~80% of the market, 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 the potential for mitigated downside risk. In addition, there is also an embedded call option on the underlying stock, through which an investor is able to participate in equity upside.

**Mandatory convertibles** typically offer 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.

**Convertible preferred stocks** — a third kind of convertible — 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 tend to mitigate risk less effectively than convertible bonds. However, convertible preferred stocks generally provide higher dividend payments than convertible bonds. This characteristic serves to compensate for the lower level of risk mitigation. 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.

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 convertible market

The convertible market provides access to capital for a wide variety of companies. Convertibles have become particularly beneficial to small and midsize companies whose low (or no) credit ratings 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 convertible market as well (Figure 1).

The use of proceeds from new issuance has also been fairly varied. Depending on the interest-rate environment, we’ve seen companies raise funds for refinancing purposes, sometimes choosing the convertible market over other straight debt corporate markets in order to lower their coupon payments. Other recent trends include funding merger-and-acquisition activity or share buybacks to support stock prices. Increased issuance has created more diverse investment opportunities, which has benefited the broader convertible market.

FIGURE 1

## The convertible market in 2023

ICE BofA U.S. Convertible Index

Total market size	\$241.3B
Average market yield	1.9%
Average conversion premium	60.4%
Large cap (\$30B+)	20.7%
Mid cap (\$6–\$30B)	38.0%
Small cap (\$0–\$6B)	41.3%

Source: ICE BofA, as of 12/31/23.

## Distinctive opportunities

Inefficiencies in the convertible asset class provide a myriad of investment opportunities, which Putnam's dedicated convertible team 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.

"Balanced" convertibles currently represent a uniquely attractive subset of the convertible securities market. They are neither too equity-sensitive nor too bond-like (for more on bond-like qualities, see the busted convertibles discussion in the sidebar). Typically, these securities trade within a range of 40%–80% delta (see delta in the sidebar) to the underlying equity and are priced around par value. We believe this subset can achieve an equilibrium of upside equity tracking potential while mitigating downside risk, as well as an attractive current yield.

When stock prices are near record levels, valuations can become highly elevated, which in turn drives up the delta of convertible securities. When this happens, high-delta securities tend to trade almost 1:1 with their underlying equity. However, we believe balanced convertibles can provide investors a way to capture the upside of an equity rally on a risk-adjusted basis, while being able to cushion the impact when their underlying equities lose value.

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

## Examples of 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, they 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 price, 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.

### Delta

Delta estimates how the change in the price of an asset can change the price of a related security or derivative. For example, a delta of 0.50 would mean that when the price of an asset changed, the price of its related security would change by 50%.

## Advantages for investors

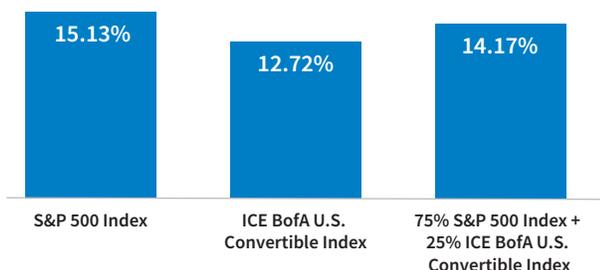
We believe convertible securities offer five main advantages to investors:

**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 those 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, 12/11–12/23)



Source: Putnam research, 2023. Index performance is not indicative of Putnam fund performance or a guarantee 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 convertible 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.

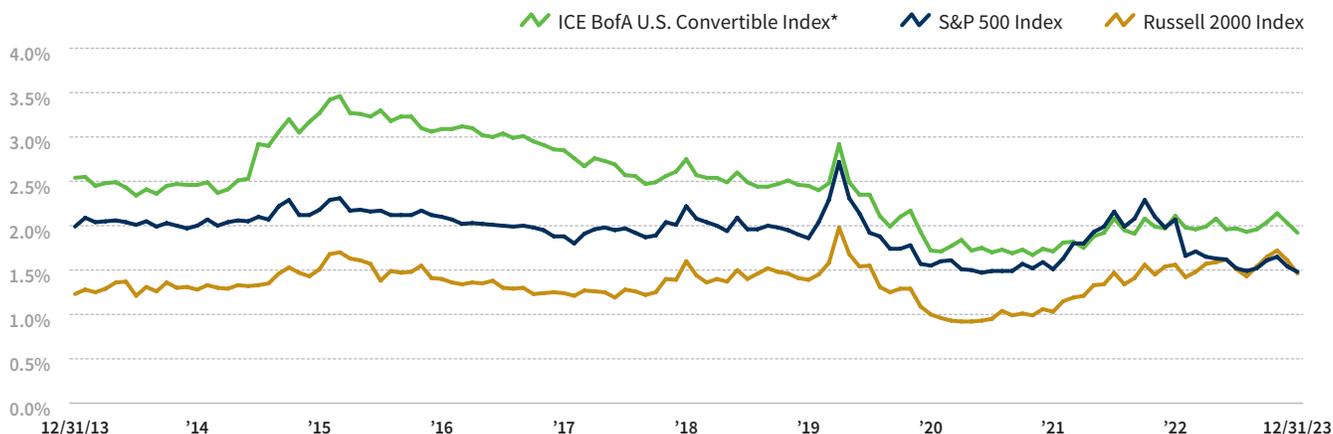
**3. Opportunity for capital appreciation** While a convertible’s fixed income characteristics can mitigate downside risk if the issuing company’s common stock performs poorly, the underlying equity option allows the holder to participate in a portion of the upside if the stock performs well. As a result, 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 potentially reduce their interest-rate sensitivity. As a result, convertible securities have historically been less influenced by interest-rate movements than bonds and have performed well in rising-rate markets, barring any major shocks to equity markets.

FIGURE 3

## Convertibles have provided higher yields than stocks (dividend yields, 12/31/12–12/31/23)



\* Current yield.

Sources: ICE BofA, S&P Dow Jones Indices, Frank Russell Company, Putnam research, 2023. 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 12/31/23)



	ICE BofA U.S. Convertible	Bloomberg U.S. Aggregate	JPMorgan Developed High Yield	S&P 500
<b>Correlation (5 year)</b>				
ICE BofA U.S. Convertible	—	0.44	0.84	0.86
<b>Risk (5 year)</b>				
Sharpe ratio	0.63	-0.13	0.37	0.75
Standard deviation	15.94%	6.11%	9.57%	18.37%

Source: Putnam research, 2023. 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 (ICE BofA U.S. 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.

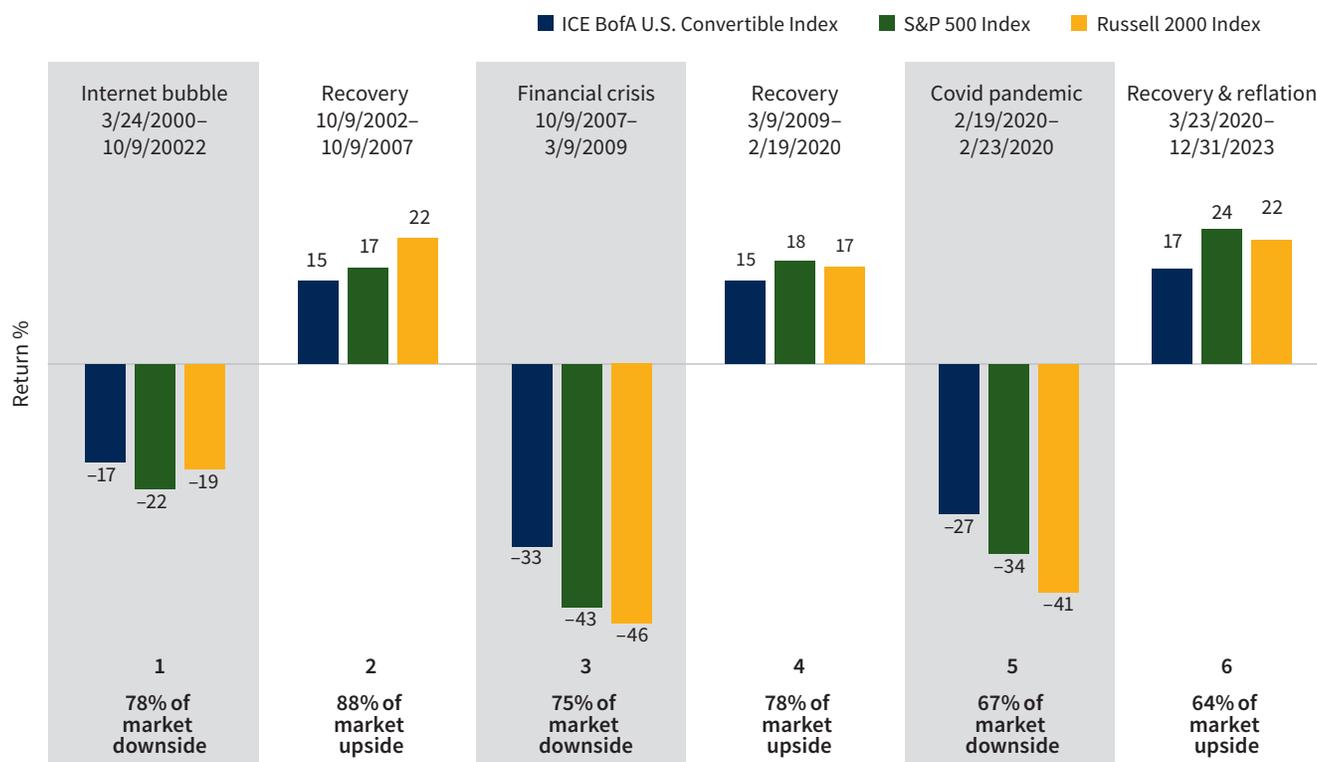
### The Putnam difference

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 convertible 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 35 years of experience, specializes in analyzing convertibles from a fixed income perspective. Anthony Daigle, with 17 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 while mitigating downside risk



Source: Putnam, as of 12/31/23. All returns are annualized. Market upside/downside reflects the performance of the portfolio versus the average return of the S&P 500 and Russell 2000 Index. Upside/downside capture ratios are calculated using daily gross returns of a U.S. Convertible Securities representative account for the past 6 time periods versus the ICE BofA U.S. Convertible, S&P 500, and Russell 2000 Index. Past performance is not a guarantee of future results. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

As portfolio managers, we are able to leverage the substantial resources of the firm'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 as of 1/31/23, and are not intended as investment advice. They are also subject to change with changing market conditions.

The ICE BofA 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 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. The ICE BofA U.S. Convertible Index is an unmanaged index of high-yield U.S. convertible securities. The Russell 2000® Index is an unmanaged index composed of approximately 2,000 of the smallest companies in the Russell 3000® Index as measured by their market capitalization. You cannot invest directly in an index.

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**Consider these risks before investing in a convertible income fund:** The value of investments in the fund's portfolio may fall or fail to rise over extended periods of time for a variety of reasons, including general economic, political, or financial market conditions; investor sentiment and market perceptions; government actions; geopolitical events or changes; and factors related to a specific issuer, asset class, geography, industry, or sector. These and other factors may lead to increased volatility and reduced liquidity in the fund's portfolio holdings.

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 generally 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.

Our investment techniques, analyses, and judgments may not produce the intended outcome, and the investments we select for the fund may not perform as well as other securities that were not selected for the fund. We, or the fund's other service providers, may experience disruptions or operating errors that could negatively impact the fund. You can lose money by investing in the fund.



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