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Convertibles offer beneficial hybrid features in elevated equity markets

With the normalization of monetary policies globally and equity valuations at elevated levels, investors may seek to increase exposure in alternatives rather than plain vanilla bonds and stocks.

Convertible securities offer attractive hybrid features of current income and total return potential that may be less sensitive to rates and equity valuations.

Historically, convertible securities have provided attractive risk-adjusted returns and an element of diversification from traditional stocks and bonds.

After an extended bull market in global equities and corporate credit securities, investors may be thinking about reallocating assets within their portfolios. Investors seeking attractive risk-adjusted returns should consider an allocation to convertible securities, which offer many of the advantages of both equities and fixed income in a single investment. As hybrid securities, this asset class offers some potential benefits including the ability to participate in rising equity markets along with a degree of downside protection thanks to the characteristics convertibles share with fixed-income securities. Currently, convertibles also offer an attractive income stream with limited exposure to the risk of rising rates.

Performance potential: Equity exposure with less historic volatility

Convertible securities are typically issued as bonds or preferred shares that pay current income while giving the owner the right to convert the security to a specific number of shares of common stock at a predetermined "conversion" price. Convertibles tend to take on their equity characteristics during rising markets due to an embedded call option feature that links the securities to the performance of their underlying stocks.

When the underlying stock price is higher than the conversion price, the convertible is "in the money" and behaves more like a stock. In this case, the convertible has a higher delta, or greater price sensitivity to changes in the underlying stock. When the underlying stock price falls below the conversion price, the convertible is "out of the money" and has a lower delta. In this scenario, the convertible behaves more like a bond and is therefore less equity sensitive.

Over time, convertible securities have generally provided asymmetric returns — capturing more of the upside potential when stock markets rallied and experiencing less downside price deterioration than stocks when equity markets declined. Furthermore, convertibles have offered returns more in line with large-cap stocks, on average, in rising equity markets while generally helping to protect principal when equity markets were falling.

From December 31, 1994, through December 31, 2016, the annual average upside capture rate for convertibles was 74%. Conversely, the average downside capture rate for the same time frame was 44%. Convertibles generally moved lower during market declines, but at a slower rate than stocks because the coupon and the issuers' obligation to repay the investors at par upon the bonds' maturities helped support the convertibles' valuations.* The bottom line? By losing less ground in declining equity markets and capturing a significant portion of their upside performance over time, convertibles may continue to offer investors a superior risk-adjusted return alternative to directly owning stocks.

* Sources: Putnam, BofA Merrill Lynch, as of 12/31/16. Data based on BofA Merrill Lynch U.S. Convertibles Index. Upside capture rate is the percentage that convertibles increased in value relative to their underlying stock price increases in up years. Downside capture rate is the percentage that convertibles decreased in value relative to their underlying stock price decreases in down years. Past performance is not a guarantee of future results.

An attractive diversification opportunity for more conservative investors, convertibles have often outperformed fixed-income assets

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 YTD
HIGHEST RETURN	GL EQ 20.07%	GL AGG 9.48%	US Govt 12.39%	GL HY 60.91%	US Conv 16.77%	US Govt 9.02%	GL HY 18.29%	GL EQ 26.68%	US Conv 9.44%	GL Conv 3.83%	GL HY 15.69%	GL EQ 13.47%
	GL Conv 15.42%	GL EQ 9.04%	GL AGG 4.79%	US Conv 49.13%	GL HY 15.26%	US IG 8.15%	EM Bond 17.44%	US Conv 24.92%	US IG 7.46%	EM Bond 1.18%	US Conv 10.43%	US Conv 10.47%
	US Conv 12.83%	US Govt 8.66%	US IG -4.94%	EM Bond 29.82%	EM Bond 12.24%	EM Bond 7.35%	GL EQ 15.83%	GL Conv 13.03%	EM Bond 7.43%	US Govt 0.86%	EM Bond 10.15%	EM Bond 8.98%
	GL HY 10.80%	GL Conv 8.59%	EM Bond -12.03%	GL EQ 29.99%	GL EQ 11.76%	GL AGG 5.64%	GL Conv 11.26%	GL HY 7.27%	GL EQ 4.94%	US IG -0.68%	GL EQ 7.51%	GL AGG 7.22%
	EM Bond 9.86%	EM Bond 6.16%	GL HY -26.63%	GL Conv 23.91%	GL Conv 9.38%	GL HY -3.16%	US Conv 14.96%	US IG -1.53%	US Govt 4.92%	GL EQ -0.87%	US IG 6.11%	GL HY 6.28%
	GL AGG 6.64%	US IG 4.56%	GL Conv -27.61%	US IG 18.68%	US IG 9.00%	GL Conv -4.58%	US IG 9.82%	US Govt -2.60%	GL Conv 4.73%	US Conv -2.99%	GL AGG 2.09%	US IG 5.37%
	US IG 4.30%	US Conv 4.53%	US Conv -35.73%	GL AGG 6.93%	GL AGG 5.54%	US Conv -5.18%	GL AGG 4.32%	GL AGG -2.60%	GL HY 3.00%	GL HY -3.07%	GL Conv 1.59%	GL Conv 4.93%
LOWEST RETURN	US Govt 3.48%	GL HY 2.09%	GL EQ -40.71%	US Govt -2.20%	US Govt 5.52%	GL EQ -5.54%	US Govt 2.02%	EM Bond -5.25%	GL AGG 0.59%	GL AGG -3.15%	US Govt 1.05%	US Govt 3.12%

- **U.S. converts (US Conv)** are represented by the BofA Merrill Lynch U.S. Convertibles Index
- **Global converts (GL Conv)** are represented by the Thomson Reuters Global Focus Convertibles Index — hedged in USD
- **Global equities (GL EQ)** are represented by the MSCI World
- **Emerging market bond (EM Bond)** are represented by the JPM EMBI Global Diversified
- **Global aggregate (GL AGG)** are represented by the Bloomberg Barclays Global Aggregate Bond Index
- **Global high yield (GL HY)** are represented by the BofA Merrill Lynch Global High Yield IG Country Constrained Index
- **U.S. IG bonds (US IG)** are represented by the Bloomberg Barclays U.S. Corporate Investment Grade Index
- **U.S. goverment bonds (US Govt)** are represented by the Bloomberg Barclays U.S. Government Index

Data as of 8/31/17.

Diversification does not assure a profit or protect against loss. It is possible to lose money in a diversified portfolio. Past performance is not a guarantee of future results. Indexes are unmanaged and do not incur expenses. You cannot invest directly in an index.

Defensive potential: Low sensitivity to interest rates

A common misperception about convertibles is that their return performance depends more on interest rates than on other factors. However, data suggest that over time, convertibles are driven more by the strength and weakness of the equity markets and corporate credit spreads than by rates. In fact, convertibles historically have performed well amid rising interest rates because of their sensitivity to underlying equities. In looking at the most recent rising-rate environments — 1988, 1994, 1999–2000, 2004–2006, and the current period since December 2016 — higher rates, economic expansion, and equity market strength led to solid performance for the asset class.

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Since convertibles have low duration, or interest-rate sensitivity, they do not perform like traditional fixed-income securities such as corporate bonds, which are closely correlated to U.S. Treasuries and generally fall during periods of rising interest rates. Convertibles have approximately one third the duration of longer-maturity investment-grade bonds as well as roughly half the duration of high-yield bonds — providing more support to the asset class during periods of rising rates.

Income with lower risk than equities

For investors seeking income in today's relatively low-interest-rate environment, the yield offered by convertible securities is noteworthy versus equities and some fixed-income alternatives. Also, amid current concerns about extended valuations in the equity markets, convertibles' yield advantage gives them a source of returns independent of price appreciation, and, thus, a lower risk profile than owning equities directly. Furthermore, unlike equity dividends, the convertible coupon (or dividend) is contractually guaranteed, providing investors with a more secure income stream. On August 31, 2017, the BofA Merrill Lynch U.S. Convertibles Index offered a 3.01% yield that was roughly the equivalent of that of the Bloomberg Barclays U.S. Corporate Bond Index (3.07%) and greater than that of the S&P 500 Index (2.00%).

Best of both worlds

Convertibles offer investors a unique opportunity to capitalize on the structural advantages of both equities and fixed income. On one hand, convertibles can benefit from both the attractive current income and downside protection offered by fixed-income characteristics, a benefit that eludes investors in common stock. At the same time, convertibles can profit from the potential price appreciation of the issuer's common stock, a benefit that eludes investors in corporate bonds. The ability to appreciate more in price than they can fall makes convertibles rare among fixed-income investments, while they also offer a lower correlation to both U.S. Treasuries and investment-grade corporate bonds.

Ultimately, in diversified investment portfolios, the inclusion of convertibles aims to improve risk-adjusted returns. As a result, institutional investors seeking lower portfolio volatility can potentially benefit from allocations to the asset class in their investment programs.

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