OAKTREE INSIGHTS

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THE CASE FOR CONVERTIBLE BONDS

OAKTREE

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"Convertibles are particularly versatile securities. Managed according to Oaktree's approach, they tend to share in most of the gains when the stock market does well and provide a measure of protection when the stock market does poorly. This makes them a good way to invest when the outlook is uncertain . . . and I think the outlook is always uncertain."

– Howard Marks

KEY POINTS

- Global convertible issuance has surged in the wake of the COVID-19 outbreak. The $92 billion of convertible securities issued year-to-date (as of June 30, 2020) is the highest first-half total on record. While much of this issuance has come from U.S.-based companies, sector and market capitalization representations have been broad.
- The global convertibles market today includes over $380 billion of securities from 750 companies.[1] U.S. companies represent approximately two-thirds of the convertible bond universe, with the rest of the market represented by issuers in Europe (16%), Japan (5%) and Asia ex-Japan (11%; mostly China). Convertible issuers include high-growth technology and pharmaceutical corporations, as well as established industrial conglomerates.
- Convertible securities offer investors the potential for equity-like appreciation while providing the downside risk protection of a fixed income instrument. Oaktree believes the defensive nature of the asset class, coupled with the potential for future upside participation, makes investing in convertibles a compelling opportunity in today's volatile and challenging environment.
- Investors view convertible bonds as debt instruments with an attached equity option. While there are many approaches to investing in convertible bonds, we like to refer to the asset class as "equities with training wheels." Historical analysis of convertibles shows the asset class may add value to diversified portfolios.
- Convertible securities have also been one of the strongest performing asset classes in 2020, with the Refinitiv Convertible Global Focus (USD) Index gaining 5.1% year-to-date (as of June 30, 2020), versus the FTSE All-World equity and FTSE High-Yield Market indices losing 5.2% and 4.8% during the same period, respectively.

CURRENT MARKET DYNAMICS

In light of the economic stress caused by COVID-19, many cash-strapped issuers in need of liquidity have sought out cheaper ways to borrow money. The solution, in many cases, has been convertible bonds. Global new issuance of convertibles has surged in 2020, with close to $92 billion coming to market year-to-date (through June 30, 2020), higher than any first-half total on record. Much of this year's total has come from companies in the travel, leisure and retail industries, which have been hard hit by the impact of the pandemic.

For today's struggling companies, part of the appeal for issuing convertible bonds is lower cost: convertibles typically pay a lower coupon than traditional fixed income instruments due to the value of the attached equity option. Furthermore, convertible bonds often afford issuers a path to equity issuance at a premium to current market prices. These characteristics have opened the convertibles market to companies that may not otherwise have turned to such deals.

The convertibles market has been tapped for opportunistic reasons as well, primarily by companies in high-growth sectors such as technology and healthcare. These are two of the best-performing sectors in the equity market this year and are widely believed to be poised to thrive in the current volatile market environment and, in some cases, to provide much-needed solutions to the ongoing global health crisis. Examples of recent opportunistic issuers include a collaboration software company and a remote healthcare provider (see Sidebar).

In line with the surge in new issuance, performance of convertibles has been notably strong this year, with the asset class gaining 5.1% through June while global equities have declined 5.2%.[2] Convertibles have attracted investors who want to maintain the downside support of a fixed income instrument in an uncertain economic environment while also keeping the potential for upside participation should equity markets rise. Indeed, while many companies have suspended equity dividend payments amid the operational and financial disruption wrought by COVID-19, convertible bonds can offer equity investors current income in the form of coupon payments. Furthermore, cheaper pricing among the influx of these new deals has provided attractive entry points for investors.

POTENTIAL BENEFITS OF CONVERTIBLE BONDS WITHIN A DIVERSIFIED PORTFOLIO

Simple analysis of returns over time shows that a strategic, long-term allocation to convertibles raises efficient frontiers. Compared with a portfolio consisting of only stocks and bonds, the portfolio with convertibles shows similar returns but with a much lower standard deviation, as shown in Figure 1 (see next page).

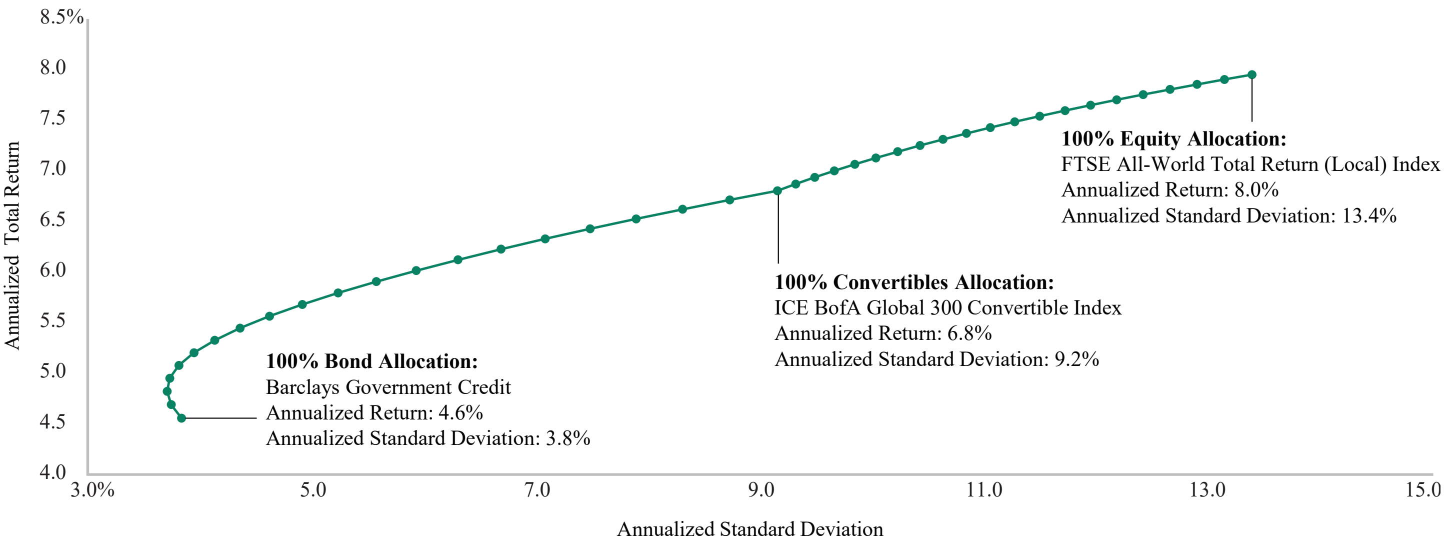
Below are some reasons investors may add convertibles to their portfolios:

- Fixed income investors: Convertibles may 1) enhance traditional fixed income returns through exposure to equity-driven price increases; 2) reduce the impact of rising interest rates, due to more potential return coming through the convertible's equity option; or 3) increase alpha with their asymmetric return profiles (i.e., more upside potential than downside risk).
- Equity investors: Convertibles may 1) provide current income and protection against severe market declines; 2) add diversification benefits; or 3) create "equities with stabilizers" (i.e., reducing downside risk without forgoing all upside potential).

A business communication software platform issued about $860 million worth of convertible bonds in the second quarter to further finance its growth. This five-year convertible bond seemed well-positioned given its senior unsecured ranking and its long-dated call option on the company's equity. The equity and convertible bond were up approximately 30% and 20%, respectively, from early April through June, already providing convertible investors an attractive return through the market's recent volatility.

A leading telemedicine company, which provides a network of on-demand remote doctors available 24/7 for consultations, raised $1 billion in May to refinance existing debt and add to its robust balance sheet for future growth. The seven-year convertible was issued with a 1.25% coupon and 35% conversion premium. In recent months this company has witnessed significantly higher levels of app downloads and a broadening of its health plan relationships. Its stock and convertible were both up approximately 10% from mid-May through June.

Figure 1:Diversification Benefit of Including Convertible Bonds in a Portfolio[3, 4]



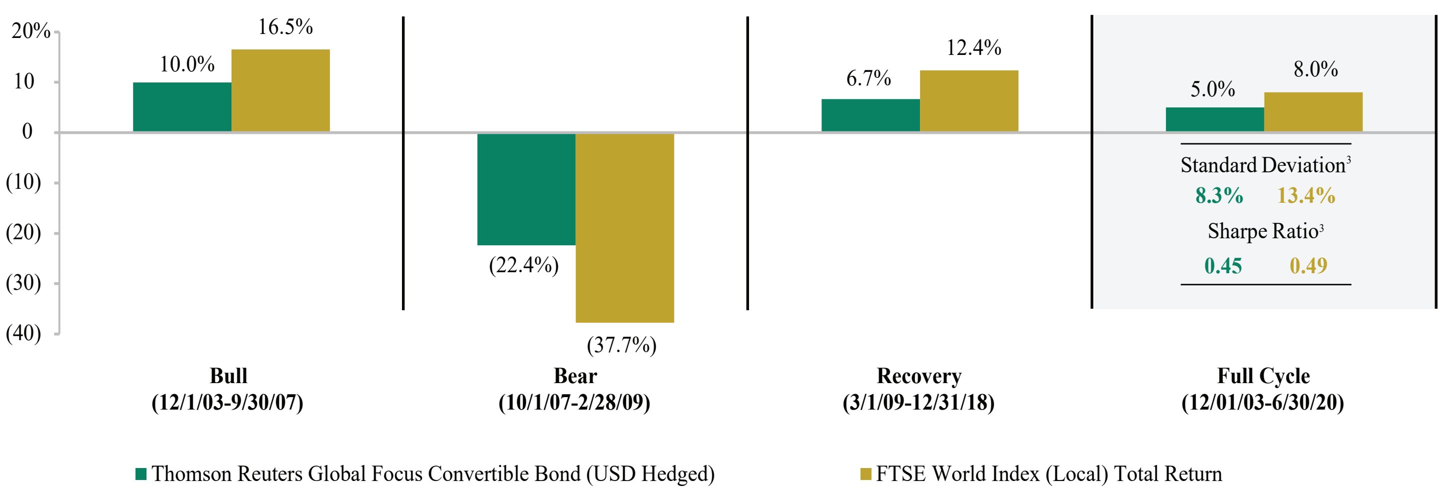
As of June 30, 2020

Convertibles are primarily issued by large corporations, but small companies that may not have public debt or long-dated equity options also avail themselves of this form of financing. Because of this, convertibles add diversification by providing investors securities they wouldn't otherwise be able to replicate with public debt and equity.

Figure 2 shows how convertibles have performed in both bull and bear markets.

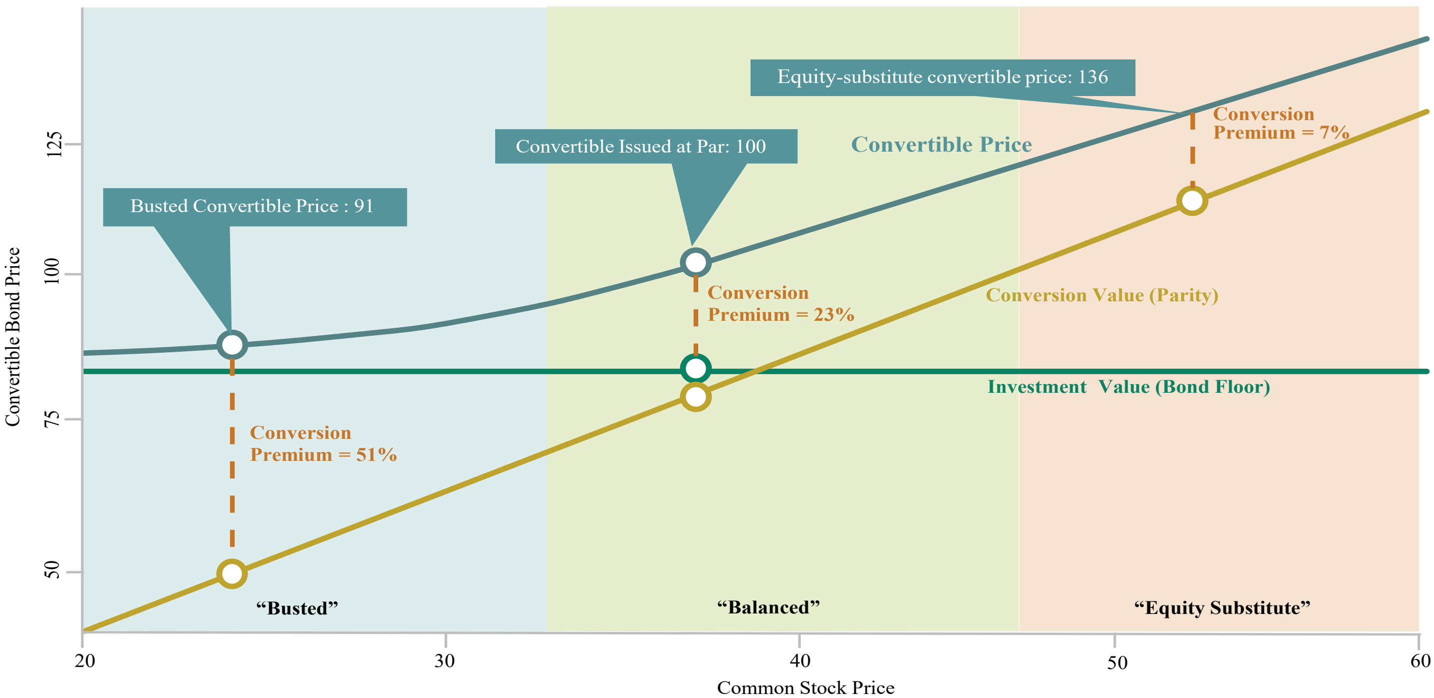
Convertibles are commonly misunderstood and under-owned, often overlooked by investors who are principally focused on equities or non-convertible fixed income investments. This can cause market inefficiencies that, in turn, can lead to bargains. Active managers positioned to achieve a "knowledge advantage" through the application of skill and specialization may be able to benefit from such gaps in the market.

Figure 2: Historically, Global Convertibles Have Performed Well in Both Bull and Bear Markets



As of June 30, 2020

Figure 3: Example Pricing of Convertible Bonds



Source: Bloomberg

CONVERTIBLE BOND RETURN PROFILE

Figure 3 shows example pricing for a convertible bond. Like other fixed income securities, convertible bonds are typically issued around par value (i.e., 100) and possess a stated coupon rate (most often fixed). The issuer will pay the coupon at regular intervals to investors. However, as the coupon is lower than what the issuer would have needed to pay on non-convertible debt, convertibles offer a call option on the issuer's stock. For a convertible issued at par, the difference between the strike price of the call option and the current stock price is the convertible's conversion premium.

As shown in Figure 3, convertibles can fit into three categories: 1) busted, 2) balanced or 3) equity-like.

- Busted: These are convertibles where the stock price (and hence the value of the convertible's equity option) has declined substantially. Barring default, the busted category shows how convertibles offer more limited downside risk than equities. Often, fixed income investors purchase busted convertibles seeking yield and, at the same time, the possibility of regaining equity optionality.
- Balanced: These convertibles exhibit asymmetric return profiles, offering more limited downside risk than upside potential. For balanced convertible bonds, investor positions have a smaller distance to fall to their "bond floors" than the unlimited upside potential offered by the underlying equity option. Convertible pricing in Figure 3 shows how the sensitivity (known as "delta"[5]) of the convertible increases as the equity rises but falls as the equity option becomes out-of-the-money. Oaktree believes that a diverse portfolio of balanced convertibles can provide attractive risk mitigation, while still potentially generating equity-like returns over time.
- Equity-like: Once an equity's price rises and the convertible's conversion premium shrinks, the convertible will begin trading in tandem with its equity. Figure 3 refers to these securities as "equity-substitutes," as they offer little downside protection given the distance they can fall to their bond floors. Most balanced convertible investors typically sell these securities (likely taking profits) when the convertible's delta approaches 100%. Equity-substitute convertibles are often owned by hedge funds and equity investors.

RISKS WHEN INVESTING IN CONVERTIBLE BONDS

Because convertible bonds are fixed income instruments, the number one risk to consider is credit risk. Convertibles are also highly correlated to equity markets. Balanced convertible bond strategies are most impacted when the value of the convertible portfolio's underlying stocks declines.

Another important risk to understand when investing in convertibles is how changes in interest rates and credit spreads impact pricing. While less sensitive than straight bonds to changes in interest rates and spreads, convertible bonds are still fixed income instruments that decline in value if interest rates or spreads increase (holding all else equal). Convertibles in the "busted" category are particularly impacted by changes in interest rates and spreads since their out-of-the-money call options provide little value.

Convertibles are also typically unsecured obligations and have no covenants. Securities are structured with features that can enhance or detract from the bond's value. Examples include call and put provisions, currency-related features and dividend protections.

OAKTREE'S APPROACH

Oaktree's Global Convertible Securities team's primary goal is to control risk by selecting money-good credits. As with other fixed income instruments, an issuer can default on its convertible by not meeting its stated coupon or principal payment responsibilities. Oaktree believes that convertible bond investing begins with the credit and that the bond floor (as mentioned above) defines the downside.

Oaktree is also highly focused on the terms and pricing of the convertible issue. Our team — which focuses on the "busted" and "balanced" segments of the convertibles universe — has a number of proprietary screening tools that filter our database of all global convertible bonds, and our investment professionals focus on securities that appear to offer the most upside potential versus downside risk. Oaktree attempts to buy convertibles that are close to the bond floor while offering meaningful equity participation and potentially a positive yield. Oaktree also conducts a thorough review of each convertible's prospectus to understand features such as dividend protection, callability, puts and takeover protections.

Once Oaktree has identified a convertible security with attractive terms and has confirmed the sustainability of the company's credit, the Global Convertibles team will analyze the convertible issuer's equity and growth prospects. This includes traditional valuation modeling, as well as discussions with company and industry contacts. While equity analysis is often a rigorous process, getting the underlying stock "right" is imperative.

Oaktree's Global Convertibles team has both generalist portfolio managers and industry-focused research analysts. The group's established team is supplemented by the broader Oaktree investment platform, which provides additional market- and company-based intelligence from synergistic strategies. Investment decisions are made by the Global Convertibles group as a whole, guided by the team members' extensive experience — an average of 20 years — working in the asset class.

The team remains mindful of the potential for volatility in the convertible bond market while seeking opportunities to invest in high-quality businesses that exhibit upside return potential.

CONCLUSION

The convertibles market provides both issuers and investors a unique hybrid debt-and-equity solution in today's uncertain economic and market environment. Historical analysis shows a long-term allocation to convertibles increases a portfolio's efficient frontier, and the asset class offers investors access to a diverse set of high-growth and established businesses. Oaktree believes its investment process, refined over the 25 years the firm has managed convertibles, may help add value for both equity and fixed income investors.

ABOUT THE AUTHORS

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Mr. Latrille is a managing director in Oaktree's Global Convertibles strategy, contributing to portfolio management, valuation and securities analysis. He joined Oaktree in 2014 from Barclays Capital where he was a managing director on the firm's U.S. convertibles bond trading desk. Prior thereto, Mr. Latrille managed a convertible arbitrage fund at Amida Capital Management. From 1994 until 2006, he held various positions at J.P. Morgan, most recently serving as an executive director on their U.S. convertibles desk. Mr. Latrille holds a Commercial Engineering degree with distinction from the Universidad Austral de Chile and an M.B.A. from the Wharton School of the University of Pennsylvania. He is fluent in Spanish.

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END NOTES

[1] Source: ICE Bank of America Securities–Merrill Lynch Convertible Research. Reflects the U.S., Europe, Asia (ex-Japan) and Japan markets. Data as of June 30, 2020.

[2] Convertibles performance is represented by the Refinitiv Convertible Global Focus (USD) Index. Global equities are represented by the FTSE All-World Index.

[3] The efficient frontier represents the annualized return for each level of risk (as defined by standard deviation) for a mix of hypothetical portfolios comprised of bonds, equity and convertible securities. For the purposes of the analysis, the allocation to bonds was assumed to be the Bloomberg Barclays U.S. Government/Credit (Local), a broad-based flagship benchmark that measures the non-securitized component of the U.S. Aggregate Index; the allocation to convertibles was assumed to be the ICE BofA Global 300 Convertible Index (Local), a global convertible index composed of companies representative of the market structure of countries in North America, Europe and the Asia/Pacific region; and the allocation to equity was assumed to be the FTSE All-World Total Return (Local) Index, a market-capitalization weighted index representing the performance of the large- and mid-cap stocks from the FTSE Global Equity Index Series. Starting on the far left, the "100% Bond allocation" assumes a portfolio made up solely of the Barclays Government Credit Index and then moves in 5% increments (with the dot just above the "100% Bond Allocation" representing a portfolio that is 95% bonds and 5% convertible securities, and so on) toward the "100% Convertibles allocation," which assume a 100% allocation to the ICE BofA Convertible Index. The "100% Equity Allocation" assumes 100% allocation to the FTSE All-World Index and then, moving from right to left, assumes an increasing allocation (with the second dot from the right representing a portfolio that is 95% equity and 5% convertible securities, and so on) to the ICE BofA Convertible Index.

[4] For optical purposes, the X,Y scatterplot for this efficient frontier starts at a standard deviation and annualized return of 3 (bottom left corner) as opposed to 0.

[5] Delta = Change in price of convertible ÷ Change in price of stock

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IMPORTANT INFORMATION ABOUT EFFICIENT FRONTIERS

The efficient frontier is a set of theoretical portfolios that intend to represent a given level of return for a defined level of risk. The efficient frontier seeks to represent theoretical portfolios that maximize returns for the amount of risk assumed. A portfolio is referred to as "efficient" if it has the highest possible expected level of return for its level of risk (which is represented by the standard deviation of the portfolio's return).

The efficient frontier is limited by a number of assumptions that may not reflect normal investment conditions. For example, one of the assumptions is that asset returns follow a normal distribution. In reality, securities may experience returns that do not follow a normal distribution. Additionally, the theory underlying efficient frontiers makes several assumptions regarding investors and markets, including: investors are rational and avoid risk when possible; there are not enough investors to influence market prices; and investors have unlimited access to borrowing and lending money at the risk-free interest rate. However, the market contains a number of risk-seeking (and in some instances, irrational) investors, significant market participants that have an influence on prices, and constrained investors with respect to borrowing.

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