Convertibles 2023 Mid-Year Update and Outlook

With the ICE BofA All U.S. Convertibles Index ("U.S. Convertible Index") up more than 6% through the first five and a half months of 2023, the asset class is demonstrating what sets it apart from traditional straight bonds.

Performance

As convertibles have an imbedded call option on the common shares of the issuing company, convertibles can provide upside equity participation while their bond features can help mitigate downside risk. This year with equities advancing, convertibles have participated in some of that upside. The 7.7% return of US Convertible Index compares to the 2.4% advance in the Bloomberg U.S. Aggregate Total Return Index as of June 15th 2023.

As is the case with the S&P 500 and NASDAQ indices, the bulk of the gains in the U.S. Convertible Index have been driven by a few large index constituents. Within the U.S. Convertible Index, approximately one-quarter of year-to-date returns have come from a single issuer, Palo Alto Networks. Our expectation is that as the year progresses and equity advances broaden, gains in the convertible market will become more widespread as well. The U.S. Convertible Index is less concentrated than it was two years ago, with no single issuer constituting more than 3% of the index, which should allow equity advances to be more broadly distributed (note that by comparison, Apple comprises more than seven percent of the S&P 500 Index).

Issuance

New issuance has rebounded from 2022's unusually low levels. Last saw year saw only $28.7 billion of new convertible issuance in the U.S. The sharp decline from $84.3 billion in 2021 was likely due to the soft equity market, as many companies did not want to issue securities linked to their shares that they believed to be undervalued. Not surprisingly, issuance has picked up this year with more than $23 billion of new convertible securities issued through the first five months of 2023. The likely catalyst for this jump in issuance is the increase in interest rates that companies now must pay to debt investors. By issuing convertible bonds, where investors have the potential for capital appreciation as well as income, companies can sell debt with a lower coupon than what would be required for an issuance of straight debt.

For investors, much of the new issuance this year has been investment grade, which was incredibly scarce for the past decade as investment grade companies could sell non-convertible debt with coupons below 3%. In addition, higher rates have forced issuers to attach higher coupons to their convertible offerings. While convertible coupons remain well below those of high-yield debt, they are significantly higher than they were just one year ago. Lastly, the conversion premiums for most new issues – the amount that the common stock price needs to rise before it becomes advantageous to convert – have returned to more historical norms of 25-35% following 2021's premiums of 50-70% for many large technology and media new issues.

With an upswing in new issuance with attractive terms, better credit quality and a rising market that may be on the cusp of broadening its gains, the second half of 2023 may be an interesting time for investors to consider an allocation to convertible bonds.

IMPORTANT DISCLOSURE

Past performance is not indicative of future results.

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ABOUT RISK

Convertible securities are subject to a risk of loss. Convertible securities may be subordinate to other securities. The total return for a convertible security depends, in part, upon the performance of the underlying stock into which it can be converted. Additionally, an issuer may encounter financial difficulties which could affect its ability to make interest and principal payments. If an issuer stops making interest and/or principal payments, an investor could lose its entire investment.

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The following indices may be referred to in this document:

The ICE BofA All U.S. Convertibles Index is an unmanaged index that consists of convertible bonds traded in the U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily.

Bloomberg U.S. Aggregate Bond Index: The Bloomberg U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. Must have at least one year to final maturity regardless of call features.Must have at least $300 million par amount outstanding. Must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Must bedollar-denominated and non-convertible.

The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

NASDAQ Composite Index: The NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

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