Widening Your Investment Spectrum: Convertible Securities

Investors tend to think simplistically in their allocation strategy. For the large majority of investors, there are stocks and bonds, with a ?60%/40%? stock/bond allocation commonplace. If one is aggressive, they may hold a higher percentage of stocks (e.g., 80% stocks/20% bonds) and conversely more bonds if one is conservative. Within those two broad asset classes, there may be small allocations to cash, non-U.S. securities such as stock and bond holdings in developed markets like Europe and Japan, and some exposure to emerging market stocks and bonds. There is nothing complicated about this approach, and it is preferred by many investment managers for this reason. At times though, when the market offers below average yields and high valuations on stocks, the strategy is not only limiting but risky. As discussed in *A Preferred Way to Generate Yield*, there are a variety of other assets for investors to explore that do not require straying too far off the beaten path of investing. **Indeed, taking the road less traveled may very well present unique opportunities merely because there is a lot less ?traffic.?** Like preferred equity securities, convertible stocks and bonds represent an often-overlooked asset class that can offer many advantages for investors willing to evaluate different parts of the capital structure. The equity, credit and volatility components of convertible securities create opportunities for investors to express a more detailed investment view encompassing a broader range of outcomes than is possible with straight bonds or stocks. As discussed in this article, the primary benefit of owning convertible securities is an asymmetric risk exposure. The bottom line: Convertibles are worth better understanding for investors seeking equity upside potential with little downside risk, along with income-producing cash flows.

What is a Convertible Security?

A convertible security is an investment that can change from one form into another. The most common types are convertible bonds and convertible preferred stock, either of which may be converted into common stock at the investors? option. In the case of a convertible bond, they pay a fixed coupon and specify a price at which it can be converted to common stock. Similarly, for a convertible preferred security, it pays a preferred dividend with a stated conversion price. The convertibility feature of these securities is akin to owning an embedded call option on the common stock. The value of the conversion feature is thus determined in the same way that stock options pricing is calculated. The conversion price, similar to the strike price of an option, is normally set above the current price on the stock. The conversion value is higher or lower depending upon how far away the conversion price is from the market price of the stock, expected price volatility of the stock and the time until the conversion period ends. Meanwhile, the underlying security, the bond or preferred stock, is valued based upon its par value and the current coupon or dividend payments. Adding the two values together offers a complete valuation of the security. The benefit of owning a convertible security is that they have a senior position in the capital structure in the case of default and yet offer the potential for equity-like upside potential. However, the benefits come at a price. Due to the added feature of convertibility, these securities have yields (coupons or dividends) that are below those offered on straight bonds or preferred stock and the price at which it is convertible to common stock is generally above the current common stock price, or ?out of the money.? The disadvantage of convertible securities is the premium paid for the option to convert to common stock. The market value of a convertible should be higher than the value of the underlying above. ıre the

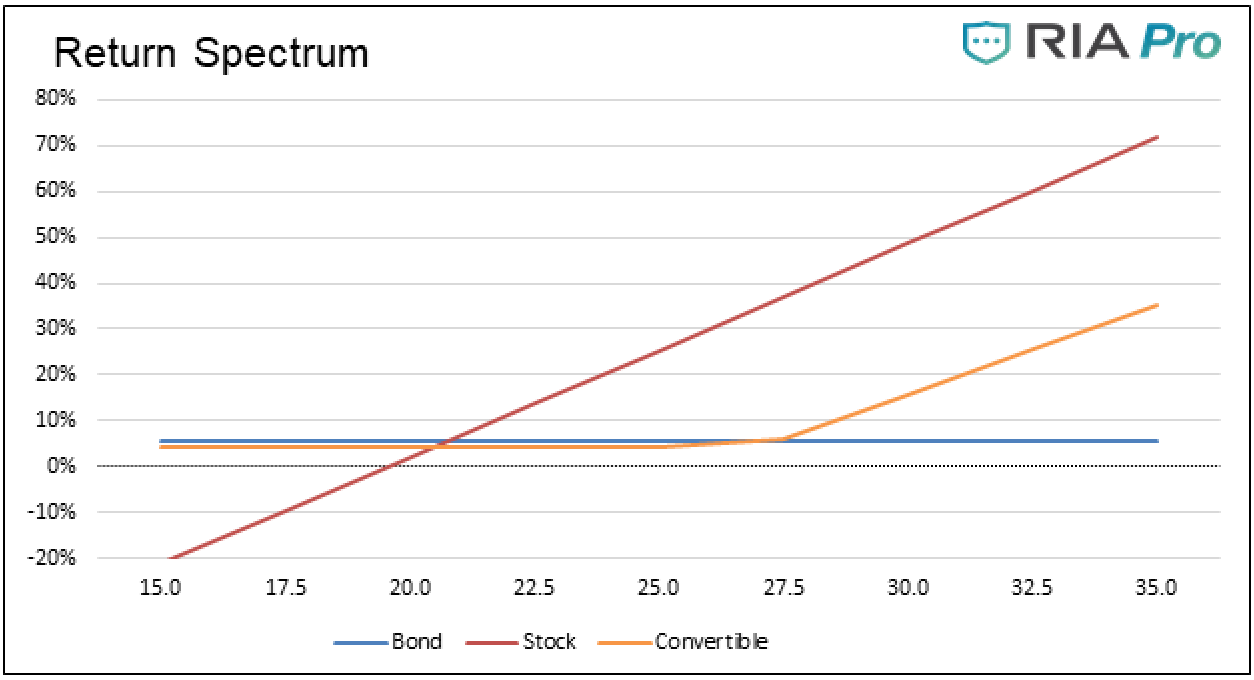
Convertible Bonds						
Company	TKR	Coupon	Maturity	Conversion Ratio	Conv Price	Curr Yield
Go Pro	GPRO	3.500	4/15/2022	94.01	10.64	8.21
Tesla	TSLA	2.375	3/15/2022	3.05	327.50	-2.47
Starwood Properties	STWD	4.375	4/1/2023	38.60	25.91	4.32

Convertible Preferreds						
Company	TKR	Coupon	Maturity	Conversion Ratio	Conv Price	Curr Yield
Bank of America	BAC	7.250	Perp	20.00	50.00	5.67
Wells Fargo	WFC	7.500	Perp	6.38	156.70	5.85
Stanley Black & Decker	SWK	5.375	5/15/2020	0.62	162.21	5.61

Data

Courtesy: Bloomberg Consider an example of how each of these securities work. From the list of randomly selected convertibles above, Starwood Properties (STWD) issued a 6-year convertible bond with $1,000 par value and a coupon of 4.375%. The conversion ratio (as seen above) is the number of shares an investor will receive upon conversion, or 38.60. Using that ratio, divide the $1,000 par value by 38.60, and you have calculated the conversion price which in this case is $25.91. If the investor buys $1,000 worth of the STWD convertible bond and holds the security for three years, he will receive $43.75 per year in coupon payments or a total of $131.25. Assume in year four, the price of Starwood stock has risen to $40 per share, $14.09 above the conversion price, and the investor elects to convert the bond to common shares of stock. The new stock received represents a total value of $1,543.82 or a gain greater than 50% on top of the $131.25 in prior coupons received. If, however, the price of Starwood instead fell to $15 per share, the investor would receive the coupon payments. The cash flow from the coupons over six years would total $262.50 and he would also receive his $1,000 original investment at the maturity date. The imbedded call option would be worthless. The convertible preferred shares work similarly to convertible bonds. Again, from the table above consider the Bank of America (BAC) preferred shares. If the stock of BAC falls, the worst the investor would do is to receive a $7.25 dividend payment for each share owned (par amount $100/share). BAC?s preferred security shown above is perpetual meaning it does not have a maturity like the bonds in the examples above (although some preferreds do ? see SWK above). If BAC shares rise in price, the investor may choose to convert the preferred to common stock but to do so and make money, the stock would need to be above the conversion price of $50 per share ($100/20). It is important to highlight again that convertible holders typically have a superior position in the capital structure, both for the bonds and the preferred stock, in the event of default. The following graph lays out a simplified comparison of the potential total returns of a bond, stock and convertible bond of Starwood Properties. The graph assumes a wide range of prices, a one year holding period, no changes in dividends, volatility or yields and that any conversion would occur on the final day of the period.&#2013266080; The following three STWD securities were used in this comparison:

1. Common Equity (Dividend yield 9.08%, price 21.14)
2. Debt (Maturing 2025, yield 6.029%)
3. Convertible (Maturing 2023, yield 4.319% conversion price 25.91)



Portfolio Construction

Convertible securities offer the unique ability for an investor to position in such a way as to anticipate outright equity ownership or to own the securities as a hedge. Because of the diversified nature of convertible securities, their inclusion in a portfolio normally reduces overall portfolio volatility. Risk-adjusted returns stack up favorably versus the S&P 500, investment-grade bonds and high-yield bond indices. Using price data from the past three years, convertible bonds have been correlated 81% with the S&P 500, 72% with high yield bonds and only 32% with investment grade bonds. Allocating 10% of investments toward convertible securities either through the Barclays convertible bond ETF (CWB) or a group of well-selected individual securities and combining it with a 55/35 stock bond allocation has the potential to improve risk-adjusted returns for traditional 60/40 investors. The versatility of convertible securities becomes clearer when considered within the context of an investor?s goals. For equity investors, they may offer equity exposure with downside protection. For credit investors, they offer greater upside than straight bonds offer.

Convertible Market Performance

Due to the low level of interest rates and tight spreads which reduces the coupon or dividend, convertible securities have largely been out of favor since the financial crisis. With the absolute level of interest rates rising, demand for convertibles has perked up as witnessed by convertible issuance which has risen to the highest level since 2007. Additionally, total return performance in 2018 outperformed the S&P 500 and High-Yield indexes, as bouts of higher volatility hurt both sectors. As interest rates rise, corporations will increasingly look to issue convertible bonds to offset some of the rise in interest rates and reduce interest expense as convertible bonds may be issued at a lower coupon than non-convertible bonds. Additionally, an increase in equity market volatility should also raise the comparative attractiveness of issuing convertible securities as the embedded option value increases with higher implied volatility. For the issuer?s standpoint, convertible securities are a means of monetizing that higher volatility. Using CWB as a performance proxy, convertible bonds performed better than other categories on a relative basis. Comparative performance with other asset classes over different time frames is illustrated in the table below.

*Total Return Performance (as of 12/31/18)					
Security	2018	2-Year	3-Year	5-Year	**Sharpe Ratio
US Convertibles Liquid Bond Index	-1.79%	7.33%	8.45%	6.60%	1.1220
CWB - Convertible Bond ETF	-1.96%	6.49%	7.83%	6.02%	0.7980
S&P 500	-4.39%	7.91%	9.24%	8.48%	0.4270
LQD - Investment Grade ETF	-3.79%	1.49%	3.04%	3.17%	1.2160
HYG - High Yield ETF	-2.02%	1.94%	5.62%	2.66%	1.0590

** Annualized total return.*

*** Sharpe Ratio over 5-year time frame.*

Data

Courtesy: Bloomberg According to Goldman Sachs Investment Research, using data going back to 1990, convertible securities have outperformed both the S&P 500 and high yield bonds in periods of rising interest rates (using changes in 10-year yields).

Conclusion

Convertible securities allow investors to engage in an asset class that permits a nuanced refinement of ways to both generate better returns and more effectively hedge risk. These dynamic and compelling securities can enable a strategy that is both useful and under the radar of most investors. Although becoming familiar with convertibles requires some effort, they afford the ability to play chess rather than checkers and there is nothing esoteric or overly-complicated about them. Furthermore, the benefits include a more efficient and well-protected portfolio which can deliver better risk-adjusted returns for both equity and credit investors alike.