The Evolving Role of Convertible Securities

An Interview with Patrick McElroy, Portfolio Manager, ClearBridge U.S. Convertible Securities

Q. How are institutional investors using convertible securities in the current environment?

Convertible securities offer significant benefits, particularly in the current environment when enhanced yields and reduced volatility are in high demand. Based on recent conversations with institutional investors, ClearBridge has learned that the role of convertibles within a portfolio varies significantly. Some institutions consider convertible securities as part of the fixed income allocation and some as part of the equity allocation. Logically, convertibles might be considered part of fixed income as approximately 80% of the current convertibles market consists of bonds, while the remainder consists of preferred stock. The value of the embedded equity option, however, is one reason why some investors treat convertibles as part of their equity allocation, substituting convertibles for common stock when the embedded option looks inexpensive.

Based on the risk-adjusted returns achieved by convertibles over time, certain institutions also have started to view convertibles as an alternative or complement to alternative investments such as hedge funds. This latter view supports allocating a separate slice of the portfolio pie to convertibles or including convertibles as part of an opportunistic credit allocation that also might include private credit and distressed debt.

Investors utilize convertible securities to reduce overall portfolio volatility, enhance fixed income returns and reduce interest rate risk via the shorter duration of convertible bonds. Many institutional investors are fans of convertible securities, particularly in the current environment when they offer attractive yields and reduced volatility.
of these securities as they are in effect paid a fixed income coupon while waiting for equity price appreciation. This annual cash-on-cash return can be material for institutional investors — a university endowment, for example, with a yearly payout. Because of their yield and higher place in the capital structure, convertible securities also represent a less volatile way to invest in growing companies.

Since they originated in the mid-1900s as a means of financing for capital-hungry railroads, the convertible securities market has grown not only in size but also in diversity of issuers. Issuers today range from rapidly growing small and mid cap companies to large cap household names.

Q. You said some investors are starting to see convertibles as an alternative to alternatives?

We have seen evidence of this lately. One of our clients, for example, noted that, based on the Sharpe ratio or return per unit of risk, convertible securities look great relative to other asset classes, including alternative investment strategies such as private equity with much higher fees. This client, an organization that started with convertibles as part of its equity portfolio, now has altered its investment policy to allow for a separate convertible allocation. Treating convertibles as its own asset class makes it possible to measure performance clearly, with separate performance measurement for equity, fixed income and convertibles. A separate allocation to convertibles also facilitates complementary positions in different kinds of convertible managers — combining those that are equity sensitive, for instance, with those that are more bond like.

Q. Why have a separate allocation to securities that in effect combine the characteristics of equity and fixed income? Don’t investors get the same exposures simply by owning stocks and bonds?

No. Convertibles have distinct, differentiated risk and return characteristics relative to stocks and bonds and behave differently from stocks and bonds in different market conditions. One endowment we spoke with, for example, pointed out that the dynamics of convertible securities — powerful embedded options on securities that can be significantly over- or undersold — make them very different than any other asset class. Some convertible managers, by temperament and experience, also tend to have an orientation toward equity-like or bond-like convertibles. The beauty of our approach at ClearBridge is that we build the portfolio one security at a time, but always based on a well-defined top-down outlook. So our portfolio reflects the available opportunity set — as opposed to having a predetermined equity or bond orientation.

The portfolio allocations shown on this page are for illustrative purposes only. “Alternatives” typically refer to hedge funds, private equity, real estate and other real assets. Benchmarks: Hedge Funds: HFRI Fund Weighted Composite (USD), Convertibles: BofA Merrill Lynch All Convertibles All Qualities, Private Equity: PowerShares Global Listed Private Equity Portfolio NAV.
Favorable Upside/Downside Capture
A primary draw for investors is the asymmetric risk/return profile of convertible securities. Over time convertibles have captured significant upside with less downside in relation to the underlying common stock.

With convertible bonds, even if the equity does not appreciate in value, you get your principal back in a few years plus the coupon. So convertibles are a great way to participate in these more volatile technology and small cap companies.

Q. What do you see as the primary opportunities for outperformance in the current ClearBridge portfolio?

In the current environment of low interest rates and tight spreads, we don’t see a lot of opportunities in the yield-oriented or bond-like convertibles. By contrast, during the period of high interest rates and wide spreads following the 2008 credit crisis, most of our portfolio was invested in yield instruments, a strategy that ultimately worked out very well for our clients.

Going forward, we believe we are going to have to select the right securities to allow us to benefit from the upward movement of stocks. So our portfolio at present is by design more equity sensitive. At this time we also see a lot of attractive convertible securities issued by companies in biotech and information technology, including some interesting small cap names. Some of the biotech names in particular have seen huge positive moves and then oversold significantly. There is good representation of these companies in the convertible market, and we believe now is an excellent time to buy them.

That’s in the current environment. In any environment, we see opportunities for outperformance based on certain inherent inefficiencies relating to the way these securities are priced. For example, the corporate bond and the option are priced separately, which means there will be situations when the two trade below their intrinsic value, providing convertible investors an opportunity to get the bond plus the stock option for less than they would cost if they were traded separately. Those kinds of inefficiencies have always existed in this market, regardless of whether conditions favor stock-like or bond-like convertibles.

Another built-in inefficiency is that 40% of the convertible securities market is unrated. Many small, attractive companies that choose to issue convertible bonds do not have any other debt at the time of issuance, so they prefer not to spend the time and money required to get rated. This is an advantage for a firm such as ClearBridge with extensive research resources. Often we already have been covering the company for some time and have a view on its prospects before the convertible is issued.

In sum, whole convertibles frequently are priced less than the sum of their parts and much of the market is unrated. This presents a classic case of “in complexity lies opportunity.” Even as the market grows and gains popularity, we don’t see these inefficiencies going away any time soon.

Q. Given the upside/downside capture and the risk-adjusted returns, why don’t more institutional investors own convertible securities?

There are many different reasons. First, the convertible securities market is small — at approximately $500 billion, the global convertibles market is a tiny fraction of global stock and bond markets totaling $225 trillion. So even though convertible issuance is growing, there still is limited capacity in the asset class and limited capacity means limited coverage by institutional consultants.

Second, there may be lingering negative associations based on the now much-diminished role of leveraged convertible arbitrage. Arbitrageurs using leverage previously dominated the convertible securities market, resulting in steep price declines when the margin calls came rolling in during the 2008 crisis. Today, the market is more robust with significant participation from long-only investors, including many mutual funds.

A third reason why institutional investors have not actively taken advantage of this asset class may have to do with the complexity of convertible securities. Investors tend to want something high octane or an anchor, not a hybrid — even

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Investors tend to want something high octane or an anchor, not a hybrid — even though the hybrid nature of convertibles is precisely what translates into the potential for attractive risk-adjusted returns. Many institutional investors also have constrained resources, which by definition constrains the appetite for doing something different.

**Q. You’ve described current market opportunities reflected in the portfolio. What is your long-term philosophy on how to outperform in this market?**

ClearBridge believes we can capitalize on market inefficiencies most effectively through in-depth understanding of both the structure of the convertible security and the underlying company. To assess the risk/reward of individual securities and the portfolio, such understanding is critical. We believe that concentrated, high-conviction, truly active portfolios of 40 to 60 securities provide the best potential for long-term outperformance. This belief leads to building portfolios from the bottom up, one security at a time, although always in the context of a well-defined top-down outlook. We focus on the quality of each individual investment as opposed to the benchmark or our outlook for specific sectors. For us, it’s all about constructing portfolios based on the best available opportunities.