Convertibles – The Strategic and Tactical Argument for the Asset Class

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Convertible bonds are unique instruments which combine attributes of fixed income and equity securities, providing the income and redemption features of a traditional bond, along with the potential for equity upside participation. While investors may pay a small premium over traditional fixed income and equity assets for this attractively asymmetric risk-return profile, the inherent “convexity” of convertibles’ structures has allowed the asset class to capture a greater portion of the equity market’s upside returns relative to the downside. For over 40 years, convertibles have navigated multiple market cycles and have historically provided improvement to the risk-adjusted returns of traditional 60/40 portfolios as well as alternatives-focused portfolios.

While the case for a strategic allocation to convertibles is demonstrated in this paper, it would be helpful to look at the unique challenges posed by the current global macro environment that argue strongly for a tactical tilt to the asset class at the present time. In summary, unprecedented monetary policy actions across the developed world have elevated risk free assets to historic levels, driving up the valuations of the entire spectrum of risk assets, and driving down prospective returns. As a corollary it has become increasingly challenging for pension plans, insurance companies and other institutional players to attain their relatively high return targets without exceeding their risk budgets. Juxtapose this against recent policy moves that point to an inflection point in macroeconomic policy, and the need to evaluate each asset class in terms of its resilience to a macroeconomic regime change cannot be overemphasized.

Macroeconomic Overview

Sovereign debt valuations are at record levels. Unconventional policy measures were adopted by central banks in response to the Great Recession, the European sovereign debt crisis, and deflationary forces in Japan. Quantitative Easing (“QE”), on an unprecedented scale, was adopted by the Federal Reserve under Ben Bernanke and emulated by BOJ and ECB. These policies have driven down global real interest rates and elevated asset prices. Over $13 trillion of the developed world’s sovereign bonds carried a negative nominal yield immediately after the Brexit vote, representing over 30% of the developed world’s sovereign debt outstanding. The percentage of sovereign debt sporting a negative real yield is higher now, and real treasury yields in the US are lower than any time since 1979.

We are at an inflection point in the policy that lead to elevated valuations. The Federal Reserve has already signaled an intent to gradually normalize policy. Subtle policy shifts by ECB and BOJ in their latest meetings point to their reluctance to deliver infinite QE and dissatisfaction with lower and negative bond yields. The BOJ’s effort to steepen their yield curve has been a catalyst for a recent rise in sovereign bond yields. Inflation in the US has stabilized and is starting to gradually creep up, just when the policy backdrop is becoming less accommodative. By implication, fixed income markets seemed priced for perfection, with very little inflation risk priced in. "Interest Rate Risk" is quite unattractive to assume at the current time for a medium to longer term investment horizon, and thus duration mitigation in investments is an attractive characteristic.

Source: Bloomberg

US Equity valuations seem elevated on an absolute basis. The slowdown in global GDP, fallout from commodity deflation, and a stronger currency has caused a string of negative earnings comparisons for the S&P 500. However, on a relative basis, equity valuations still look attractive, especially when compared to fixed income. Macro headwinds, from a continuing slowdown in China to the potential for economic shock from Brexit in Europe after Article 50 is invoked by the UK, raises the prospect of muted equity returns with moderate drawdowns along the way. Central bank liquidity has tempered volatility for the present moment. Yet, a gradual normalization of monetary policy by the Fed is likely to reduce some of the excess liquidity, causing an upward bias in future volatility.

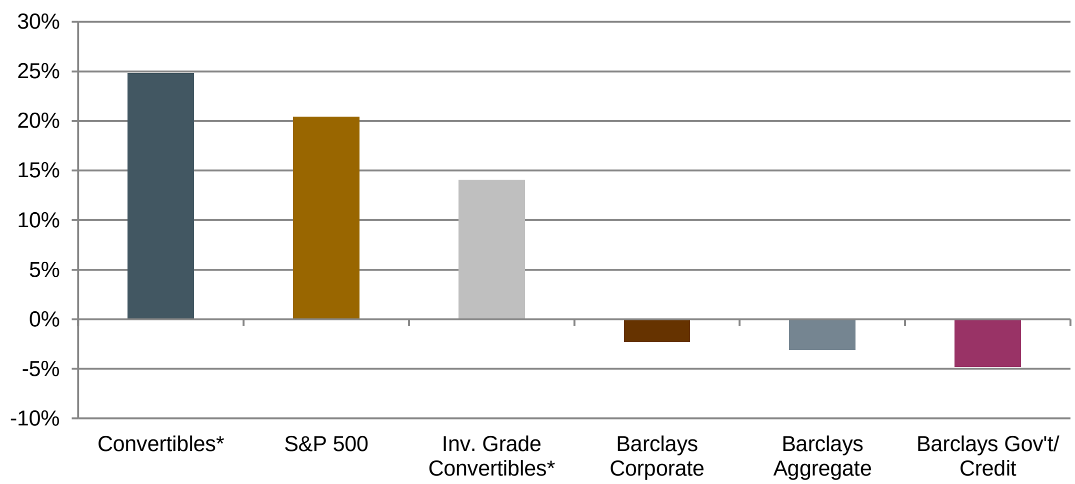
Source: Bloomberg

Credit markets still seem attractive on a longer term comparison based on long standing relationships between spreads and default rates. An exposure purely to spread while removing the duration risk by shorting treasuries, or by other duration mitigation strategies, seems to be the way to gain exposure to this attractive asset class. Additionally, strategies that can gain from a potential increase in currently depressed levels of **volatility** and gain diversified exposure to credit are likely to produce superior risk-adjusted returns on a medium term horizon. In sum, the current environment calls for strategies that can mitigate duration risk and gain exposure to equities, but minimize drawdowns by truncating the downside. This naturally brings the conversation to convertible securities, as the asset class addresses each of these points.

The Case for Convertibles

Given the prospective macro environment of rising rates and moderate equity returns, convertibles – with their strong equity upside participation, competitive income profile, and substantially mitigated interest rate risk – are well positioned as a relatively attractive asset class. Focusing first on their bond-like attributes, convertibles immediately appear to have a current competitive advantage relative to traditional fixed income assets. In a global environment of compressing fixed income yields, and with the prospect of three potential additional rate rises by the end of 2017, convertibles provide an attractively competitive source of yield versus other benchmark asset classes, with only a fraction of the interest rate risk of traditional fixed income products. The current income yield of the convertibles universe, at 3.3%, has more than a +120 basis point yield advantage over the Barclays Aggregate Bond Index ("the Agg"), with less than half of the duration risk. The expectation is that given our macroeconomic view, convertibles could generate attractive forward returns relative to fixed income and equity markets, on an absolute and risk-adjusted basis. In fact, convertibles have historically outperformed, on average, both fixed income and equity markets during periods of rising interest rates, as illustrated below.

Average Annualized Return in Rising Rate Environments



Source: SSI internal research; BofA ML Convertible Research; Bloomberg; Barclays. Rising interest rate environment periods based on SSI internal research/evaluation where the 10-Year Treasury rises at least 100 bps in a twelve-month rolling period. Rising Interest Rates on 10-Year Treasury, 12/31/88 through 2/15/13.

Of the nine most recent historical periods during which a significant rise in interest rates occurred, convertibles generated positive returns in seven out of the nine timelines. During these periods, convertibles had higher average annualized returns than the S&P 500, while the Agg on average generated negative returns.

In addition to their ability to weather changing interest rate environments, convertibles possess positive convexity characteristics which have allowed them to capture a greater portion of the equity market's upside relative to downside. Historically, convertibles have provided 100% equity upside capture during normal, moderate equity return environments, while providing substantial protection in down equity markets. This is illustrated in our study of convertible performance in negative, normal, and high equity return months, showing that convertibles have been able to historically provide an attractively asymmetric return profile relative to equities as shown on the following page:

	Avg. Return in Negative Equity Months* <0%*	Avg. Return in Normal Equity Months 0-2%*	Avg. Return in Strong Equity Months >2%*
S&P 500 Index	-3.40%	1.05%	4.60%
BofA ML All US Convertible Index (VXA0)	-2.32%	1.10%	3.35%
Capture Rate vs. S&P	68%	>100%	73%

Source: Bloomberg. Returns sorted and categorized based on S&P 500 Index returns from 1/1/1988-9/30/2016.

We expect the downside protection in convertibles, attributable to the fixed income component of a soft bond floor, to be further enhanced by effects arising from a potential rise in volatility. Unprecedented liquidity unleashed by central bank action has suppressed volatility which currently sits at multi year lows. A drawdown in the market triggered by the withdrawal of this liquidity is likely to cause a spike in volatility. Convertibles are uniquely poised to benefit from such an outcome through the rise in the value of the equity option component consequent to a rise in volatility, potentially further enhancing the asymmetric return profile.

Given the historically greater capture of equity market upside than downside, it should follow that convertibles exhibit superior risk-adjusted return metrics relative to equities. Indeed, when comparing long term return streams, convertibles have generated superior risk-adjusted returns and competitive real returns.

20 Years: US Risk Adjusted Returns	Annualized Return	Standard Deviation	Sharpe Ratio
BofA ML All US Convertible Index*	7.36%	13.12%	0.39
S&P 500 Index	7.91%	15.35%	0.37
Russell 2000 Index	8.06%	19.92%	0.29

**Source: Bloomberg. Returns sorted and categorized based on S&P 500 Index returns. Performance as of 9/30/2016.*

Through their ideal combination of fixed income and equity attributes, convertibles are able to help protect on the downside relative to equities, while capturing a large percent of the upside. These convexity properties have allowed the convertible asset class to generate attractive real and risk-adjusted returns over both individual and multiple market cycles.

Aside from analyzing historical return patterns, when taking into account our macroeconomic viewpoint along with current market analytics, convertibles once again highlight as comparatively attractive relative to fixed income and equities. At one of the lowest levels in its history, the yield-to-worst of the Agg is currently 2.07%[1] , painting a dour picture for prospective high grade fixed income returns. Using the 10-year risk free rate and the current equity risk premium, an expected forward return can be assigned to the S&P 500 of approximately 7.75%[2] , in line with our view that the equity market currently remains more attractive to investors than fixed income, despite rising valuation metrics and a somewhat lofty earnings multiple. The equity market prospective return estimate also agrees with our view that a moderately positive equity return environment may lie ahead, during which convertibles have historically captured the bulk of equity upside returns. Indeed, utilizing the current income yield of convertibles with the 55% delta[3] (equity participation) of a typical convert, one can assign an expected return from convertibles of 7.57%[2] , or a 98% capture of equity market prospective returns. We believe this assumption could be viewed as conservative, as it ignores the cheapness of the asset class, and additionally does not take into account the high gamma of convertibles that

[1] as of 9/13/2016
[2] The calculations and comparisons used reflect the belief or investment thesis of the portfolio management team on a prospective basis, and as such, due to various risks and uncertainties, actual events or projected results may differ materially from those reflected in the document. Further notes are included at the end of this document.
[3] Source: SSI internal research

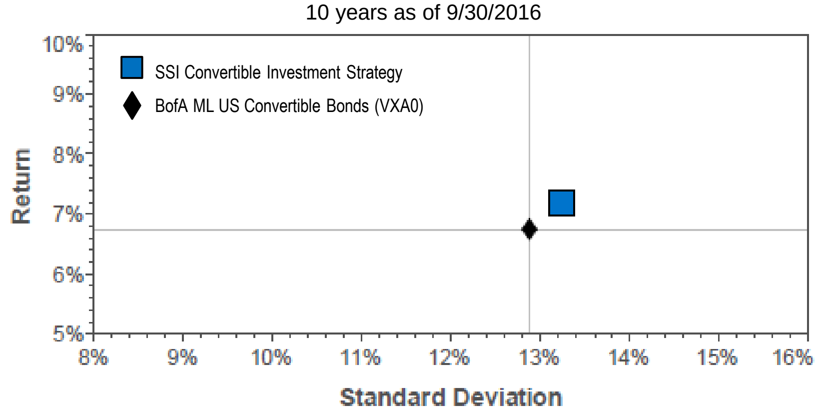
allow them to capture an increasing portion of equity upside as the market appreciates. These factors have historically led to convertibles delivering outperformance relative to expected returns which are based purely on theoretical delta. Combining the prospective returns with historical average standard deviation from all three of these asset classes, convertibles stand out as the most attractive on a risk-return basis.

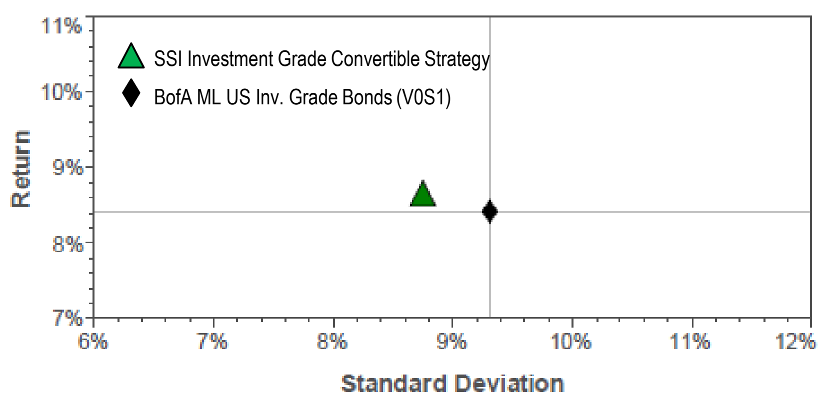
Expected Returns[1]	Expected Return	Adjusted Sharpe
Fixed Income (Agg)	2.07%	0.101
Equities (S&P 500)	7.75%	0.401
Convertible Securities	7.57%	0.484

SSI Convertible Investment Strategies

Given the myriad data presented thus far, convertibles as an asset class appear queued up for a potentially attractive forward risk-return environment, on an absolute and relative basis. As a manager of convertible securities for over 40 years, SSI's long-only Convertible Strategies have historically provided superior absolute and risk-adjusted returns versus their respective convertible benchmarks, since inception and on a trailing 10-year basis:

SSI Risk vs. Return
10 years as of 9/30/2016





Source: Zephyr StyleADVISOR. SSI performance is gross of fee. The above information is supplemental to SSI's composite presentation.

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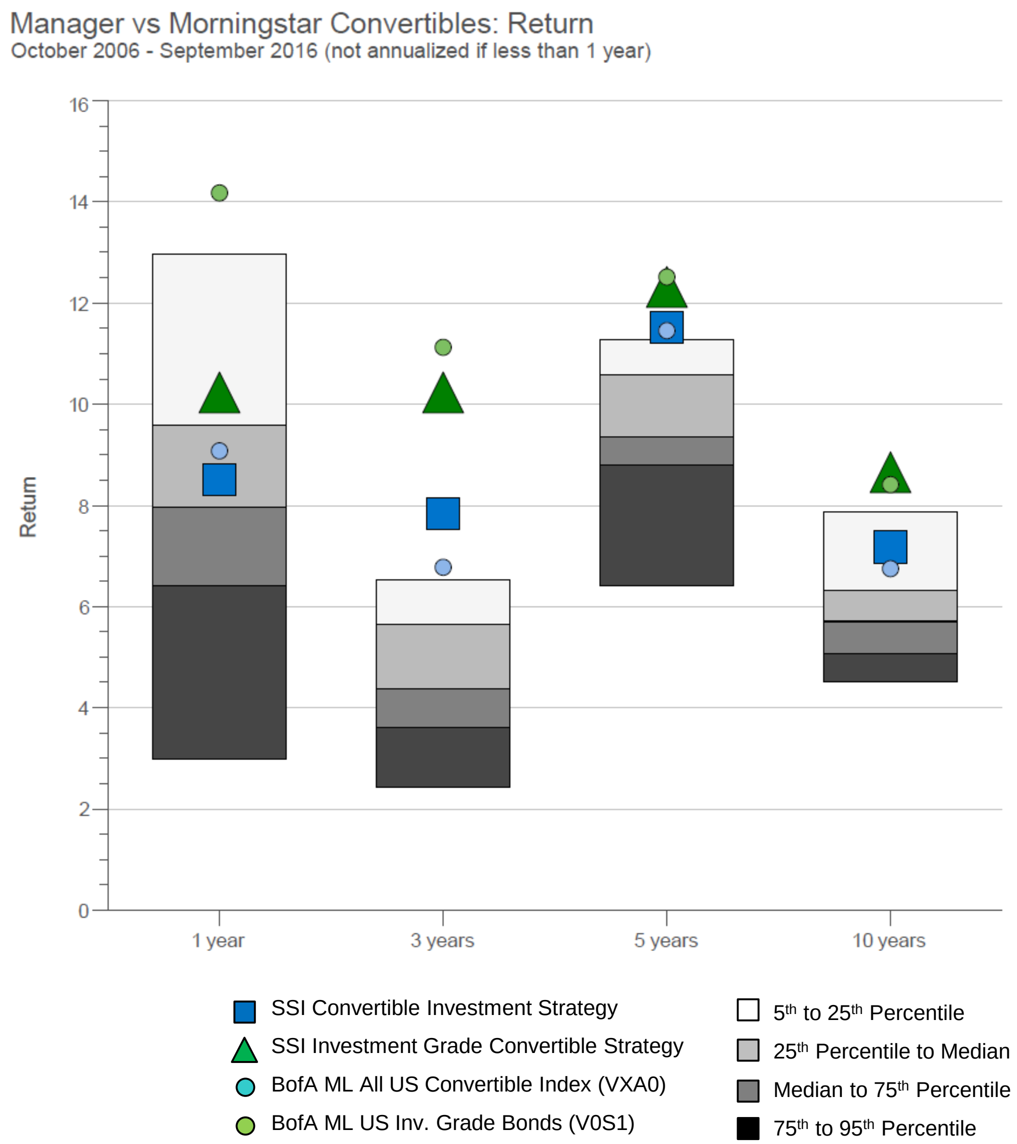
SSI's analysis of macroeconomic environments combined with proprietary convexity optimization tools have allowed the portfolio management team to enhance the asymmetric return profile of an already convex asset class. SSI's Convertible Strategies rank highly for the past 1, 3, 5 and 10 years vs. the Morningstar Convertible Universe. SSI Investment Management is ranked as a top performing convertibles manager by Pension & Investments ("P&I"), on both a 1-year and 5-year basis.



Source: Zephyr StyleADVISOR. Manager returns supplied by: Morningstar, Inc., Standard & Poors. SSI performance is gross of fee. The above information is supplemental to SSI's composite presentation.

For more information on SSI and its products, please contact the firm at 310.595.2000 invest@ssi-invest.com.

Notes on Forward Return Calculations:

The calculations and comparisons used reflect the belief or investment thesis of the portfolio management team on a prospective basis, and as such, due to various risks and uncertainties, actual events or projected results may differ materially from those reflected in the document.

1.)xpected risk free (10Y) return:	1.69%	10Y Treasury Yield 9/14/16 BBRG
2.)equity risk premium:	6.06%	T12M cash yield method 8/31/16 DAMODARAN
3.)**expected return from equities:**	**7.75%**	= ERP + 10Y
4.)typical convertible delta*:	55%	approximate effective delta of convertible universe
5.)expected equity return from converts:	4.26%	= expected equity return * cvt delta
6.)convert current yield:	3.31%	current yield of convertible universe 9/13/16 BAML
7.)**expected convert total return:**	**7.57%**	= converts' expected equity return + current yield
8.)historical 30Y std dev of converts*:	12.16%	through 8/31/16
9.)adjusted Sharpe**	0.484	average excess return above risk free ÷ std dev of historical return**
9.)expected AGG total return	2.07%	use AGG YTW as the expected return for FI (using YTM instead gives you 2.08%) 9/13/16 BARCAP
10.)historical 30Y std dev of AGG*:	3.83%	through 8/31/16
11.)adjusted Sharpe**	0.101	average excess return above risk free ÷ std dev of historical return**
9.)expected equity total return	7.75%	= ERP + 10Y from table above (#3)
10.)historical 30Y std dev of S&P**:	15.12%	through 8/31/16
11.)adjusted Sharpe**	0.401	average excess return above risk free ÷ std dev of historical return**

**Source: SSI internal research*

***As the Sharpe ratio is not available (Sharpe = standard deviation of excess return) an "Adjusted" Sharpe ratio has been calculated: standard deviation of actual returns alongside with prospective excess return*

Compliance Statement

SSI Investment Management, Inc. ("SSI") claims compliance with the Global Investment Performance Standards (GIPS®).

Definition of the Firm

SSI was established in 1973 and is a Registered Investment Advisor based in Los Angeles, CA. SSI manages assets in domestic and global capital markets. SSI acquired the assets of Froley, Revy Investment Co., Inc. ("Froley Revy") and its composites as of March 1, 2009. SSI is 100% employee owned and is not affiliated with any parent organization nor does SSI have any subsidiaries. SSI applies quantitative disciplines and fundamental research in its management of alternative and traditional portfolios for institutional and high net-worth investors. SSI manages separate accounts, limited partnerships and acts as sub-advisor to both onshore and offshore funds.

Policies

SSI’s policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request.

The Composite & Benchmark

The Convertible Investment Strategy (composite created January 1983) is invested in convertible bonds and convertible preferred stocks, and do not have credit quality restrictions. The Strategy may hold 144A securities. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the BofA Merrill Lynch All Convertibles Index (the “VXA0”) is appropriate. The VXA0 measures the return of all U.S. convertibles. SSI does not hold all convertibles in the VXA0 and may also hold convertibles that are not included in the VXA0. The Strategy is less diversified than the VXA0. The volatility of this strategy may be greater than the volatility of the VXA0 as the strategy holds a smaller number of positions than the Index. The return, if any, above the VXA0 is dependent upon SSI's discretionary management. Any other indices shown are not necessarily comparable to SSI’s Convertible Investment Strategy. These are widely recognized market indices that are shown for informational purposes only. The composite name was formally known as SSI Outright Discretionary Convertible Strategy from 1/1/1983 – 3/31/2016 and on 4/1/2016 the new composite name became the SSI Convertible Investment Strategy.

Investment Management Fees

Returns are presented gross and net of management fee. Actual results of an individual account may be materially different from the performance shown herein because of differences in inception date, transaction and related costs, restrictions, fees and other factors. All performance is based in U.S. dollars and reflect, on a percentage basis for each of the periods indicated: (a) the net increase (decrease) of all SSI Convertible Investment Strategy portfolios, dollar-weighted, including adjustments for unrealized gains and losses, the reinvestment of dividends and other earnings, the deduction of investment costs except any separate custodial or related fees, time-weighted to adjust for additions and withdrawals, and (b) the net increase (decrease) of the VXA0.

Net performance is reduced by SSI’s actual investment management fees. Gross performance does not include deduction of SSI’s investment management fees.

If performance is gross of management fees, client’s actual return will be reduced by the management fees and any other expenses which may be incurred in the management of an investment advisory account. See SSI’s Form ADV, Part 2A for a complete description of the investment advisory fees customarily charged by SSI. As an example, an account with an initial $1,000,000 investment on January 1, 2003, earning a recurring 5% semi-annual gross return (10.25% annualized), and paying a .5% semi-annual management fee (1% annual fee) would have grown to $1,340,096 on a gross of fees basis and $1,300,392 on a net of fees basis by December 31, 2005 (3 years).

List of Composites

A list of the Firm’s composite descriptions and/or compliant presentations are available upon request. Please contact juliea@ssi-invest.com.

Additional Disclosure

SSI acquired Froley Revy and its composites as of March 1, 2009. Prior to the acquisition, Froley Revy claimed GIPS compliance for the periods of 1983-2008 and was independently verified by Ashland Partners & Co.

Investors must assess the suitability of any particular investment opportunity and carry out any due diligence that they require in relation to the strategy or investments or individual holdings of the strategies that SSI manages. In doing this, investors should seek separate advice. It should not be assumed that recommendations made will be profitable and any investment is at risk of loss. This summary represents the views of the portfolio managers as of the date noted at the beginning of this document. Any holdings mentioned in the accompanying summary are from its stated strategy. Portfolio holdings are subject to change without notice and are not intended as recommendations of individual securities. The information in this article is not intended to be personalized recommendations to buy, hold or sell investments. The information, statements, views and opinions included in this article are based on sources (both internal and external sources) considered to be reliable, but no representation or warranty, express or implied, is made as to their accuracy, completeness or correctness. Such information, statements, views and opinions are expressed as of the date of this article, are subject to change without further notice and do not constitute a solicitation for the purchase or sale of any investment referenced in the article. Changes in any assumptions may have a material impact on the results. Due to various risks and uncertainties, actual events or projected results may differ materially from those reflected in the document.

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