Resilience of Convertibles in Economic Recessions

By: Ethan Ganz, Portfolio Manager

As Q3 2017 came to a close, equity investors booked another quarter of impressive returns, with tech stocks up over 20% year-to-date, and broad large and small cap stock indices both generating double digit returns for 2017[1]. While the risk premium in equities remains attractive relative to long term history, rising equity market P/E ratios are a constant topic of conversation on quarterly investment updates. One of our core principles at SSI is preservation of capital. So, as we watch the markets rise and rise, we are reminded to stick to our discipline, which means we have to consider what the world would look like when tides shift. Indeed, we are currently in the third longest expansionary bull market since the mid 1800's, monetary policy is shifting, and there has been a sea change in governmental leadership, in both the U.S. and abroad, that could have lasting impacts on the global economy.

With investor and advisor sentiment being affected by themes posed above, mentions of a "recession" have been increasing in news stories and research reports, and recommended investment strategies for the years ahead are becoming more polarized.

"Our official call is for continued moderate growth in 2018-2019… [but] we will be watching incoming data closely to determine whether conditions that could lead to a recession/slowdown starting in late 2018 are developing. We would encourage decision-makers to do so as well."

- John Silvia, Chief Economist at Wells Fargo (Sept 2017)[2]

Some economic indicators seem to point to a later-stage bull market with near to intermediate-term recession, while others push out probabilities significantly. The yield curve has been on a flattening trajectory for years, and incipient inflation pressures are certainly present, evidenced by disappearing slack in the labor market and potentially rising commodity prices. These factors are often present leading up to a yield curve inversion, and ultimately an economic recession.

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Additionally, as the Fed moves from data dependency to path dependency, the likelihood of a misjudged rate hike is increasing, putting further pressure on the yield curve. However, while inversion has typically been used as a predictor of impending recession, the current environment has some important differences from prior late-bull markets, including low absolute levels for both fed funds and inflation. Several factors point to the idea that waiting for yield-curve inversion may limit an investor's ability to predict the next recession. The investment community is indeed split on their views of the probability and timing of the next recession.

Economists at Wells Fargo have been reporting a more accurate and earlier predictor of recession by isolating a new relationship between fed funds and the 10-year treasury, specifically during rising fed funds cycles. The signal triggers if, during a rising fed environment, the fed funds rate touches/crosses the lowest level of the 10-year during that same cycle. Our most recent rising rate environment began back in December 2015 when the fed funds target rate was raised from 0.25 to 0.50. Since then, the lowest level of the 10-year treasury was 1.36, in July 2016. Using this model, the signal will trigger once the fed funds target rate crosses above 1.36. If the Federal Reserve raises rates in December 2017 as expected, the target rate will be 1.50, indicating an elevated chance of recession starting within the next year and half, according to their model.

Regardless of what stage we are at in the current bull market, there will certainly be a U.S. recession at some point in the future. By examining the performance of convertible securities through both recessionary and expansionary periods, this study aims to show that a constant allocation to convertibles could be a benefit to the real and risk-adjusted returns of equity portfolios. This improvement has historically been magnified during periods of recession.

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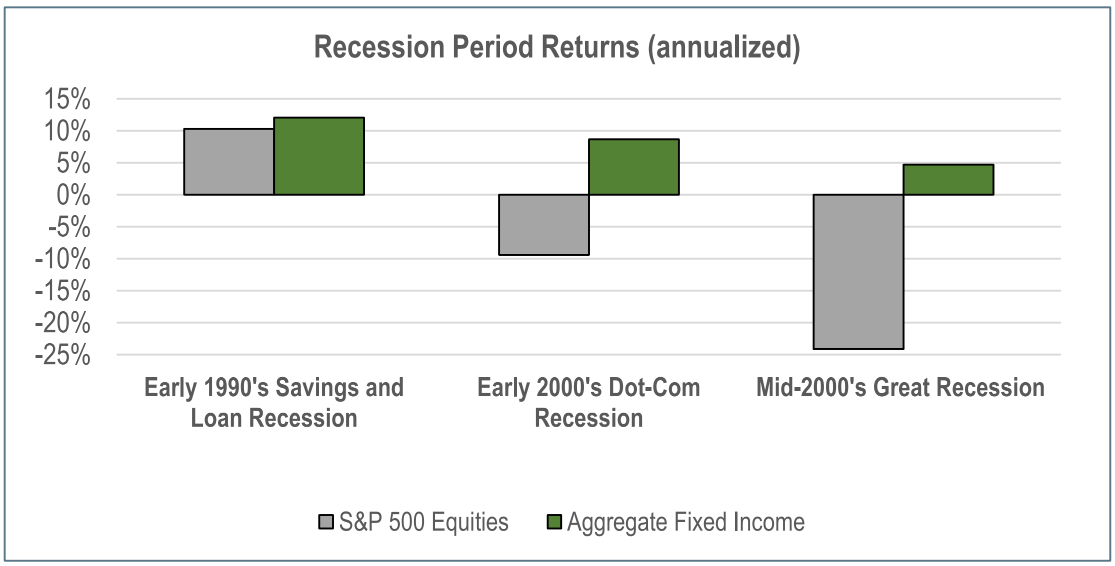
For the purposes of this study, the National Bureau of Economic Research's (NBER) definition of recession is used, incorporating trends in several economic indicators, rather than requiring two consecutive quarters of decline in real GDP[3]. Since the mid 1900's, the average recession has lasted about a year, while the typical expansion clocks in at around 5 years. The recessions highlighted in this study are the most recent three experienced in the U.S., namely the 1990's Savings & Loan crisis (just after the inception of the VXA0 convertible market benchmark index), the early 2000's Dot-com bubble, and the mid-2000's Great Recession. With the exception of the Savings and Loan crisis, when PCE deflators were still quite high and both asset classes rose in value, the last two out of these three recessions exhibited fairly typical behavior, with equities heavily underperforming or selling off, and fixed income securities generating relatively high returns:



Source: Bloomberg & NBER

In fact, ever since the inception of the Aggregate Bond Index (1976), fixed income securities have, on average, booked gains while stocks have generally maintained or lost value during a recession. Convertible securities, with their combination of equity and fixed income attributes, are generally viewed as a low-volatility equity surrogate. Given these attributes, expected and realized returns for convertibles often fall somewhere in between those of equity and fixed income assets.

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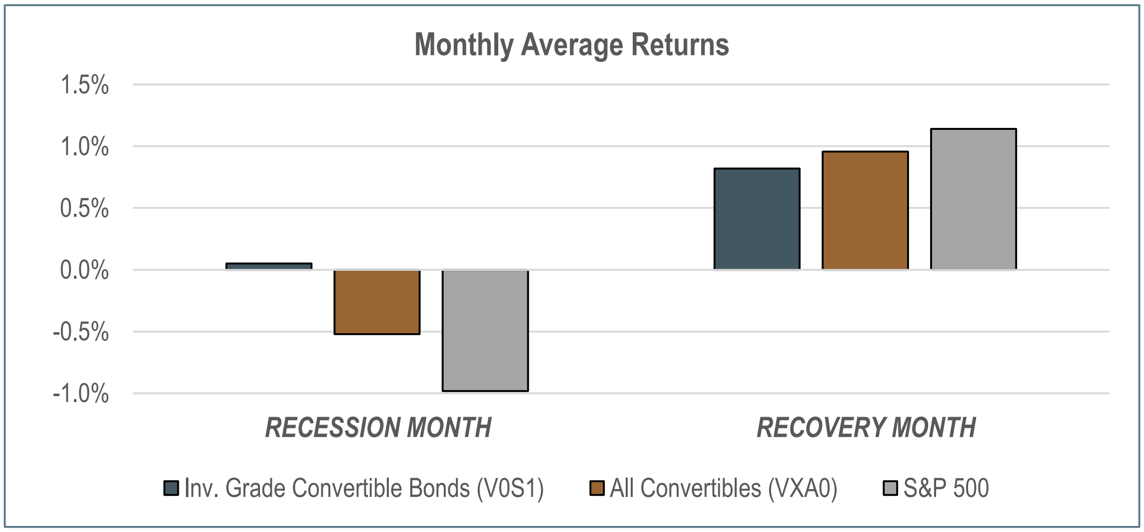
The expectation would follow that during a period of recession, convertibles may drop in value, but not to the extent of equities. Conversely, during an expansionary period, convertibles could be expected to realize a meaningful portion of equity market returns. These themes are evidenced in actual returns over the past three cycles:



Source: Bloomberg & BofA Merrill Lynch & NBER

During the cycles measured in this study, the average recessionary month saw the broad market of convertible securities capturing only about 50% of the downside equity return, while convertibles captured almost 85% of the upside equity return during the average month of economic expansion. In the narrower investment grade bonds-only convertible market, the average month of recession actually produced a positive return in IG convertible bonds, while they captured about 72% of the equity market's upside during the average recovery month. The high credit quality, high bond floor, large cap and bonds-only nature of investment grade convertibles have certainly factored into their historical outperformance during periods of economic distress.

Along with superior average absolute returns during recessions, convertible securities have also historically exhibited more attractive risk-adjusted returns versus equities during these sell-offs, due to their dampened volatility.

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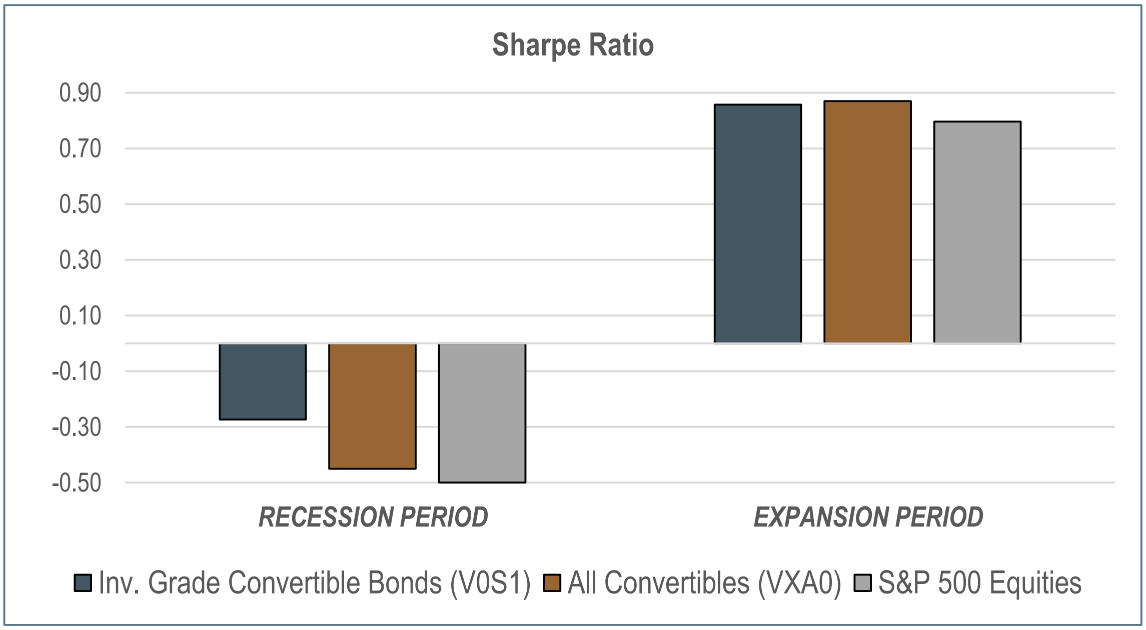
On the flip side, while convertibles have generated an attractive partial upside capture of equity returns during recovery periods, their risk-adjusted returns have actually been superior:



Source: Zephyr StyleADVISOR & NBER

Given the data presented thus far, three notable conclusions about convertibles can be stated. First, convertibles have captured a high percentage of equity upside in expansionary markets. They have done so with higher risk-adjusted returns than equities. During these periods, the average investor could benefit from diverting a portion of their regular equity allocation to convertibles, particularly from low-volatility or options strategies. Second, convertibles have had much better returns than equities during an average month of economic recession, capturing only a portion of the downside in equities (or actually generating positive returns, as in the case of Investment Grade convertible bonds). Over the course of these recessionary periods, convertibles have also exhibited much higher risk-adjusted returns than equities. During recessions, it seems that investors could benefit even more greatly from replacing a portion of their equity allocation with investments in convertibles, through fully discretionary and/or investment grade mandates

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> *In both expanding and receding markets, convertibles have shown to provide a benefit to traditional equity portfolios.*

The final conclusion of this study brings us back into the "now" moment. Even as economists and investors are split on when the next recession will come, and what affects it will have on financial markets, mentions of "recession" in the news and in economic research are on the rise. While a U.S. recession may or may not be in the near future, our recovery has been historically lengthy, and at some point the tides will turn. Since the constant benefit of convertibles relative to equities appears to have been magnified during prior recessions, investors could theoretically reap extra benefit from beginning to pivot portions of their equity allocations into convertibles now, ahead of a market sell-off, while the prospects of a future recession may be on the rise.

Notes:

[1]Tech stocks: Nasdaq / Large Cap Stocks: S&P 500 / Small Cap Stocks: Russell 2000

[2]John E. Silvia, "Is the Yield Curve Enough to Predict Recessions?", September 18, 2017, Special Commentary-Economics Group-Wells Fargo Securities
https://www08.wellsfargomedia.com/assets/pdf/commercial/insights/economics/special-reports/recession-prediction-short-20170918.pdf

[3]Information on NBER's economic cycles can be found at http://www.nber.org/cycles.html

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