2021 Mid-year: Convertible Commentary and Outlook

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Performance Recap

The Convertible Market generated positive returns and outpaced major fixed income asset classes in the first half of 2021. As represented by the ICE BofA ML All US Convertible Index (VXA0), the asset class returned 6.90%. This was primarily driven by strong performance of the underlying equities at 12.45%. Convertibles benefited from strong returns in cyclical market segments, while balanced Convertibles outperformed equity like Convertibles and yield alternatives.

2021 Performance *(as of 06/30/2021)*	
Underlying Equities of the Convertible Asset Class US All	12.45%
VXA0	6.90%
S&P 500	15.24%
S&P 500 Low Vol	9.33%
Russell 2000	17.53%
Bloomberg Barclays High Yield Bond Index	3.62%
Bloomberg Barclays US Corporate Inv. Grade Bond Index	-1.27%
Bloomberg Barclays Intermediate Treasury Bond Index	-1.14%

Source: Bloomberg, BofA Global Research, ICE Data Indices LLS, year to date performance as of 6/30/21

Economy and Financial Markets Recap

As measures to fight the pandemic took effect, more businesses reopened, economic indicators improved, and U.S. GDP growth accelerated. The economy grew at 4.3% in Q4 2020, 6.4% in Q1 2021, and is forecast to grow at 10% for Q2 2021. While still maintaining highly accommodative policies, the Federal Reserve struck an incrementally hawkish tone at their June meeting. The market now expects interest rate increases and tapering of bond purchases to begin sooner than previously thought. Fiscal authorities introduced a multi-trillion dollar infrastructure plan to further economic growth. Employment trends have continued to improve, although further recovery is anticipated especially in industries most impacted by COVID. Corporate earnings exceeded expectations in Q1 2021 with S&P 500 EPS growing 52.5% compared to growth estimates of 15.5% at the start of 2021[1].

1. Source: Factset, 7/2/21

Major equity markets posted positive returns in the first half of 2021. Value stocks outperformed as investors rotated into the group due to expected leverage to a strengthening economy. Although speculative investors and leveraged hedge funds contributed to excessive volatility in selected market segments, volatility as measured by the VIX Index dropped by 30% (VIX 22.75 as of 12/31/20, VIX 15.83 as of 6/30/21) during the first half of the year. High yield credit spreads tightened by 82 basis points (ICE BofA US High Yield (H0A0) Gov't OAS 386 bps on 12/31/20; 304 bps on 6/30/21) and currently stand at multi-year lows even as ten-year treasury yields have risen from 0.92% to 1.47% during the same period.

Outlook

The macro backdrop remains supportive for risk assets. Intervention by the Federal Reserve has significantly improved financial conditions (Bloomberg Financial Conditions Index), compressing and curtailing equity market volatility despite the rise in ten-year Treasury yields this year. An economic rebound and vaccine developments have created a positive feedback loop with an infrastructure package in the trillions still to come. Inflation expectations bounced to the highest level since 2013 from a combination of fiscal and monetary policy moves, but have only rebounded to their long term average. S&P 500 earnings are expected to grow 63.6% in Q2 2021, an increase from 52.1% growth expected on March 31, 2021. 2021 S&P 500 earnings estimates have risen all year and currently call for 35.5% growth[2]. This earnings growth and stocks' attractive valuation relative to bonds should provide additional tailwinds for the equity market.

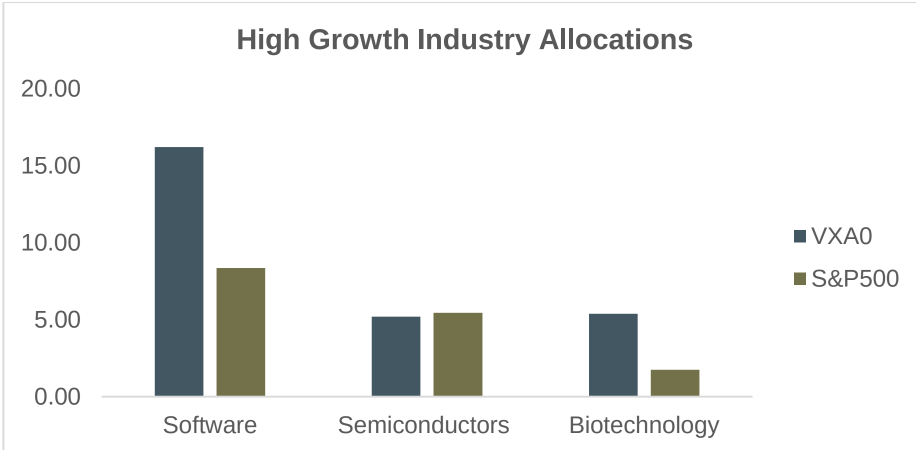
2. Source: Factset, 7/2/21

Our outlook for Convertible bonds for the second half of 2021 remains constructive. One reason is that we believe the underlying equities of the Convertible bond asset class may resume their outperformance of major equity benchmarks. The Convertible universe has been dominated by structural growth companies in the Technology and Healthcare sectors that are disruptors with large addressable markets and potential for long lasting high growth. Some of the major structural growth themes that have heavy representation in the Convertible universe are:

- Digitization of the economy and cloud computing/SAAS (Software as a Service)
- Genomics, personalized medicine, gene therapy, telehealth, and biotech M&A
- 5G build out, data center reacceleration, artificial intelligence, and automated mobility

- Green Energy: Solar, hydrogen fuel cells, EVs

These themes have a significantly higher representation in the Convert universe:



Source: Bloomberg, ICE, VXA0 represents the ICE BofA US Convertible Index. As of 5/31/21.

The strong returns by these structural growth companies in 2020 was a major reason for the outperformance of Convertible bonds. After a strong start in 2021, the underlying stocks of many of these Convertibles corrected significantly as economic reopening and rising long term interest rates sparked rotation out of these companies into cyclical sectors. With economic growth poised to decelerate from unsustainably high levels in the second half of 2021, and long term interest rates settling into a new trading range, growth may be poised for a rebound. Security selection will be key, as investors will need to be more discriminating as to valuation and determining which growth areas will persist regardless of COVID related demand surge. For example, Convertibles of cyber security companies such as Palo Alto Networks and Zscaler may outperform in the environment we foresee.

In addition to opportunities in structural growth, the Convertibles market affords opportunities in cyclical sectors that we expect to outperform as the economy transitions from early to mid-cycle. In 2020, new issuance in industries most exposed to economic recovery / reopening meaningfully contributed to outperformance. Leading groups included: retail, restaurants, airlines and cruise lines. Opportunities in these areas still exist, but we expect cyclical outperformance in 2H 2021 to be driven more by Convertibles in the Energy, Materials and Industrials sectors due to favorable supply / demand dynamics in commodities, and due to increased capital spending by businesses.

Positioning

With major equity markets near all-time highs, credit spreads at multi-year lows, and volatility decreasing from the pandemic highs, markets have experienced rapid sector and factor rotations as investors debate the key issues that will drive returns in 2H 2021. These issues include: transitory vs permanent inflation, talk of Fed tapering, tax uncertainty, potential profit margin pressures and confusion on the stage of the economic cycle. In this environment, SSI believes a "barbell" approach provides the best odds of outperformance. Unlike, 2020 where reopening plays in consumer discretionary and travel were most emphasized, cyclical reflation themes in energy, materials and industrials are expected to drive outperformance. In energy and materials supply / demand dynamics have improved, companies have consolidated and return on capital over growth at any cost has been emphasized. Select industrials could outperform as companies boost capital expenditures. For the growth portion of the barbell we overweight Convertibles of high growth technology companies with significant earnings visibility and attractive valuations relative to growth prospects. In healthcare we favor medical device companies with innovative new products and biotechnology companies with near term drug pipeline catalysts. At this point in the economic cycle we believe it is too early to have significant exposure to defensive areas of the market such as consumer staples and utilities.

New Issuance

- Following a record year in 2020, Convertible bond issuance remains robust in 2021. Through June, there has been $59.7b in issuance[3], on pace to exceed last year's record and provide a significantly expanded investment opportunity set.

  3. Source: Barclays, 7/2/21
- The blend of new issues has been attractive with many structural growth cloud software, digital media and biotech companies, as well as cyclical value companies in the consumer discretionary, industrial and basic materials sectors in the mix. New issues are typically highly convex and therefore enhance the risk/reward profile of the overall portfolio.
- Given that the typical Convertible issue usually comes to market with terms for 5-7 years, this supply is likely to help maintain a healthy market for years to come.
- The new issuance in the market not only creates more sector diversification, but also provides a growing opportunity for active managers to invest in balanced Convertibles which in our view provide the most favorable risk/return profile.
- Balanced Convertibles exhibit characteristics of both equities and bonds, leading to an asymmetric profile that many investors favor. These securities are commonly characterized by moderate yields, stock price sensitivity, and convex return pattern, which provides meaningful downside protection.

ICE BofA All US Convertibles Index (VXA0)*	Market Value of U.S. Convertible Market ($mn)	Balanced Convertibles %	Market Value of Balanced Convertible ($mn)
12/31/2018	$170,727	39%	$67,276
6/30/2021	$354,452	44%	$156,278

** Source: BofA Global Research, Global Convertibles Chartbook, 7/2/21*

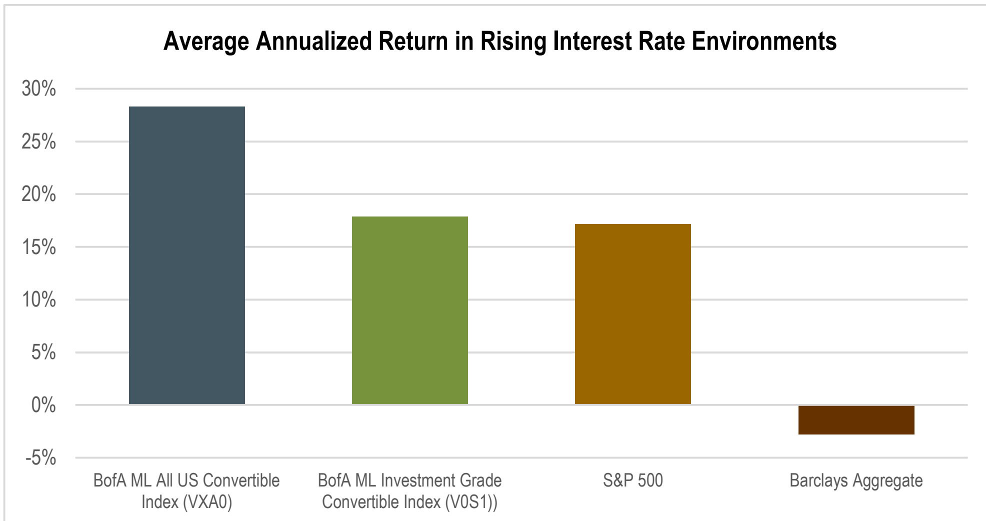
From 12/31/2018 until 6/30/2021, the U.S. Convertible Universe (as measured by the VXA0):

- **108%** increase in total market value
- **132%** increase in total market value of the balanced Convertible market
- The size of the balanced segment of the Convertible market, which represents securities with the most favorable risk/return profile, on 6/30/2021 is **92%** of the entire market value of the U.S Convertible universe at the end of 2018.

The Case for Convertibles in 2021 and beyond:

- Convertibles are one of the few asset classes that contractually **provide downside protection** as the principal and coupon are protected and senior to equity claims.
- Convertibles provide **exposure to fast growing, transformative companies** in the Technology and Healthcare space with **meaningfully truncated downside** and reduced risk. They provide risk controlled exposure to some important secular tends and to disruptive companies serving large addressable markets. Currently, they also provide exposure to attractive cyclical recovery stories starting with attractive equity valuations against an improving macro backdrop through attractively priced securities
- Convertibles are **a great fit for low vol equity** allocations. A low volatility quant equity strategy is likely to be skewed in favor of Utilities, Consumer Staples, and REITS, with underweights in Technology and Healthcare. By contrast, Convertibles have a high representation in Technology and Healthcare, along with underweights in Consumer Staples and Utilities. Therefore, Convertibles can provide meaningful diversification benefits to a portfolio, along with the ability to significantly truncate the potential volatility from exposure to these high growth sectors.

- **Convertibles are also a great fit as a diversifying option within a fixed income allocation**. They have a significantly lower duration than Corporate bonds or the Barclays Aggregate and thus have historically outperformed in rising interest rate environments (see chart below). The issuer composition for Convertibles is very different than high yield bonds and thus provides effective diversification. In addition, the historical default rate for Convertibles is significantly lower than high yield bonds.



**Convertibles: ICE BofA All US Convertible Index (VXA0); Investment Grade Convertibles: ICE BofA Investment Grade US Convertible Bond ex-Mandatory & Preferred Index (V0S1).*

- **Convertibles outperform equities during economic recessions**, on both an absolute and risk adjusted basis. Were there to be a double dip or a W shaped recovery, converts are likely to do a good job of protecting on the downside as they did just recently in Q1 and the first half of 2020 as well as in prior episodes of recessions.