

Convertible IQ

Convertibles - A Superior Fixed Income Alternative in a Rising Rate Environment

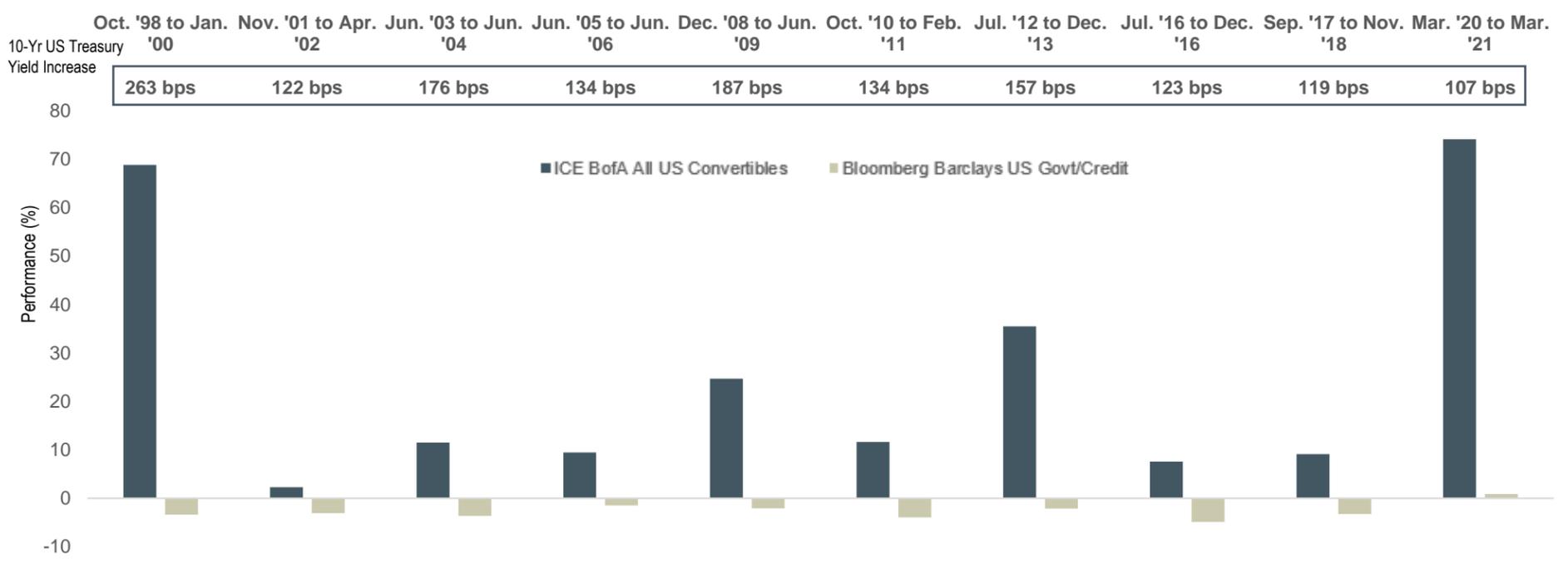
Yields on longer-dated treasury bonds rose sharply over the past year, igniting investor concerns about the impact of rising rates on fixed income returns. The absolute level of yield on the 10-year treasury has historically been the best predictor of 10-year forward returns on fixed income, which makes it difficult for allocators to meet their return goals. In the short run, the path for rates seems headed higher fueled by vaccination driven reopening, and monetary and fiscal stimulus. This is happening at a time when credit spreads in high yield securities have compressed to record lows, while investors chase yield and illiquid assets, amidst a highly stimulatory monetary policy and a sea of liquidity.

Given the still low levels of yields and spreads, near term fixed income return distribution is likely to be more skewed to the downside, more so in the treasury complex, but also to some extent in high yield, as there is very little room for spread compression to offset rising yields. This challenges the role of fixed income as a diversifier to equities in asset allocation. Given that the outlook for absolute returns from fixed income over the next decade is challenging, investors need to explore alternative solutions in order to reach return targets, while mitigating multiple risk components.

Convertible securities pose an inviting option for those looking for less interest rate risk exposure in a fixed income allocation. What makes Convertibles especially attractive is their historical performance during periods of rising interest rates. An actively managed Convertible allocation can provide a strategic hedge against an eventual rise in interest rates due to a relatively lower duration profile for Convertibles (currently about one third that of the Barclays Aggregate index)* and higher current yield. Over the past year, as rates have risen by more than 100 bps, Convertibles have performed very well. While Convertibles do have some sensitivity to interest-rate fluctuations, albeit muted, historically they have performed well in a rising interest rate environment.

As the chart below illustrates, Convertibles have consistently delivered strong performance in a rising rate environment as opposed to traditional fixed income. With interest rate risk on the rise, this is an opportune time for allocators to seriously consider Convertible securities with an active manager to mitigate the risks arising from rapidly rising yields.

Convertible Bond Performance in a Rising Interest Rate Environment*



* Sources: SSI internal research, BofA Global Research, Bloomberg Barclay Research, and US Treasury. Rising interest rate environment periods based on SSI internal research where 10-year US Treasury yield increased by at least 100 basis points (bps) from October 1998 to March 2021. Performance reflected is cumulative.

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