

Viewpoint

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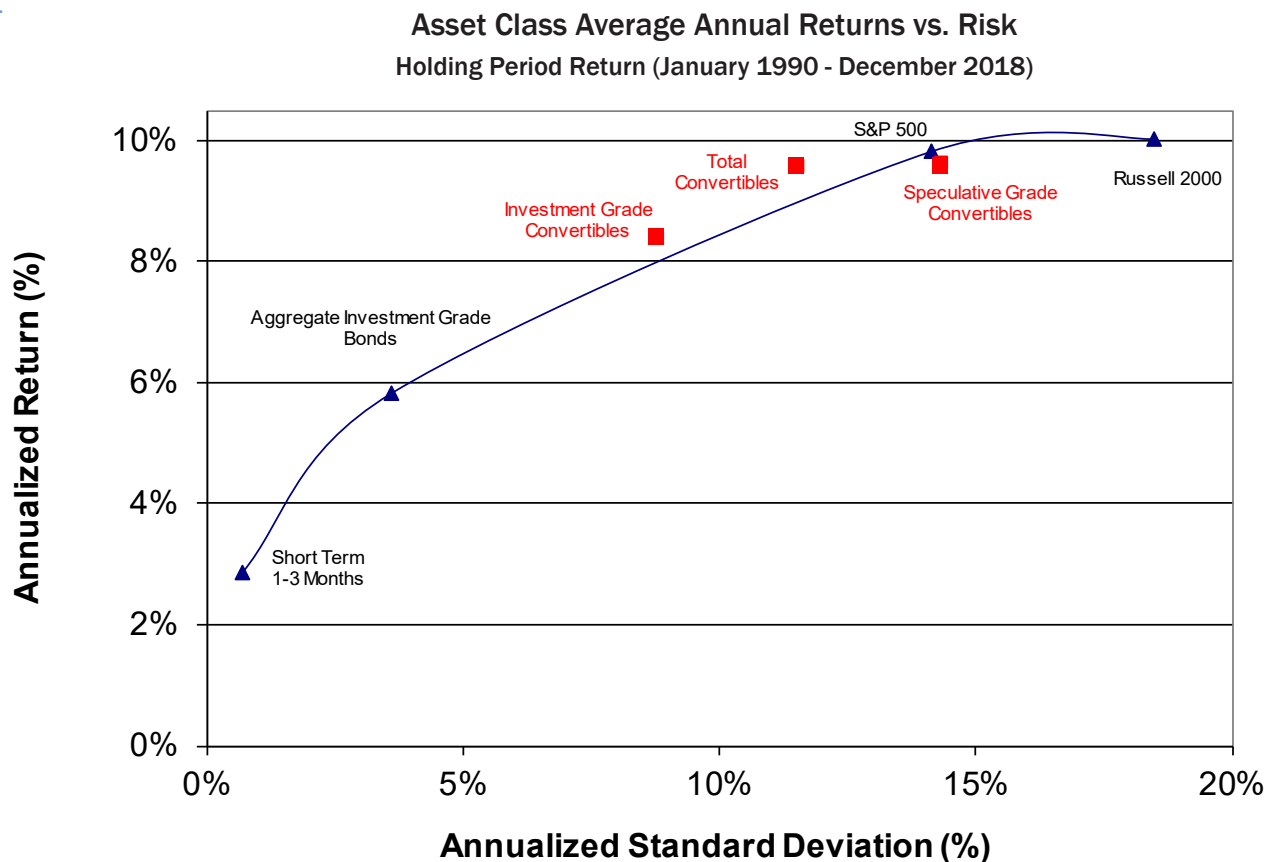
Convertibles: A Flexible Asset for Insurance Portfolios

By David Tyson, Ph.D., CFA, Managing Director and Portfolio Manager

Rising market interest rates have piqued curiosity in convertible securities, but many insurers do not fully understand how convertibles work or their potential portfolio benefits.

The unique feature of a convertible bond – it can be converted into the issuer’s equity – speaks to its value proposition: potential equity upside with a bond’s downside protection. (Figure 1 illustrates convertibles’ place in the risk/return spectrum, generally between bonds and equities.) The need for capital growth while maintaining a stable asset portfolio to match liabilities should drive insurers’ interest in convertible bonds.

Figure 1



As of December 31, 2018. Prepared by Conning, Inc. Sources: Bloomberg Index Services Limited. Used with Permission; ICE Data Indices, LLC, is used with Permission; © 2019 London Stock Exchange Group plc and its applicable group undertakings; and ©2018 Standard & Poor’s Financial Services LLC (and its affiliates, as applicable). Indices defined on pages 4 and 5. Past performance is not a guarantee of future results.

Convertibles can offer insurance portfolios the ability to enhance capital efficiency, increase diversification and adjust their overall risk profile. The challenge, however, comes in evaluating convertibles securities, both in terms of their relative bond and equity values as well as in determining a security’s fit for an insurer’s portfolio.

With the right analytical rigor, however, a selection of convertible securities may reward insurers with equity-like returns while also offering greater downside protection. The outlook for 2019 also suggests continuing growth in issuance, creating more opportunities for insurers to tap into the potential portfolio benefits of convertibles.

Benefits to Investors

Convertibles can offer insurance portfolios valuable benefits:

- **Capital efficiency** – Convertibles are treated as bonds for risk-based capital (RBC) charges because of their price floor protection. This enables their values to hold up much better in stress tests than equity securities. They have historically provided 50% of an equity premium for often less than 20% of equity RBC charges. (See Figure 2).

Figure 2

RBC vs. Returns, 2008-18: Corporate and Equity Benchmarks

	RBC Charge	Dec. 31, 2008 - Dec. 31, 2018 Returns
Bloomberg Barclays US Corporate Total Return Unhedged Index	0.64%	5.92%
ICE BofA Merrill Lynch U.S. Investment Grade Convertible Index (ex Mandatories)	0.87%	11.67%
S&P 500 Index	15.00%*	13.10%

Prepared by Conning. Sources: Bloomberg LP. RBC charges are based on the weightings of NAIC 1 and NAIC 2 holdings for each asset class.

*Charge for P/C companies - life company charges are higher.

- **Diversification** – Convertibles have a low correlation to bonds, not surprising for an asset often used as an equity substitute, which is a benefit to bond-heavy portfolios in a period of rising interest rates. Convertible issuance tends to come from less mature firms, so current issuance features higher amounts of health care and technology companies, offering greater sector diversity to a fixed-income portfolio. The risks posed by companies in the convertible market tend to be more early-stage business risk rather than the financial-leverage risk that affects the lower quality segments of the corporate bond market.
- **Risk management** – Portfolios' equity risk exposures can be fine-tuned to better meet client goals, ranging from investing in more bond-like convertibles to pursuing greater yields and capital treatment on convertibles that trade more in lock-step with the underlying equities. Convertibles can also provide a fixed-income portfolio with capital gains in a rising interest rate environment to help offset capital losses on their traditional fixed-income assets. The U.S. experience during the past 30 years is that periods of rising interest rates have been accompanied by improving economic conditions and earnings growth, which has enabled stocks and convertibles to go up in value despite the rise in discount rates.

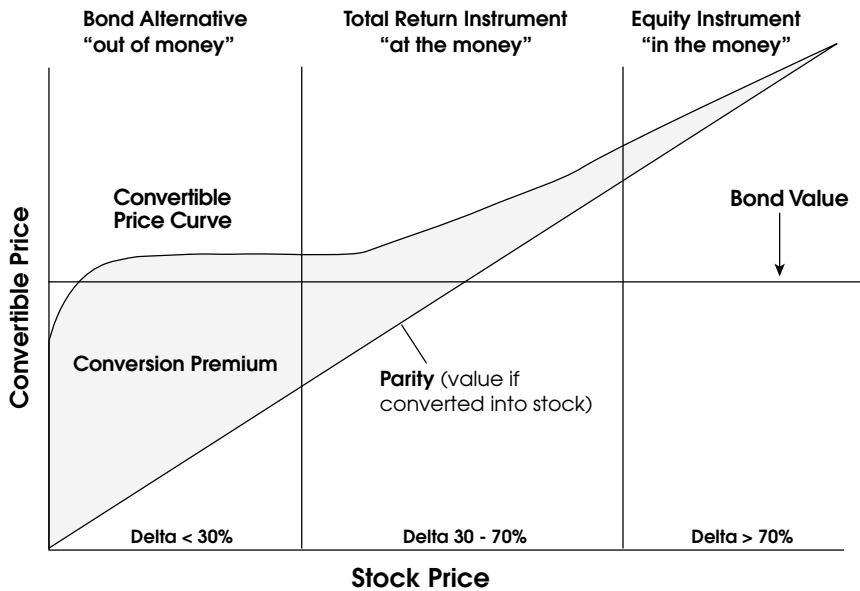
To Convert - or Not?

Investing in convertible securities requires skill in both credit and equity analyses as well as in evaluating the particular bond-equity trade-off that supports an insurer's unique needs.

Figure 3 highlights the trade-off via the price behavior of a convertible relative to its underlying stock. The straight diagonal running from lower left to upper right shows the parity value of the convertible – i.e., the value the security would have if the issue was converted into stock – which increases with the issuer's stock's price.

Figure 3

Convertible Price Behavior vs. Underlying Stock



Prepared by Conning. Sources: ICE Data Indices, LLC ("ICE DATA"), is used with permission.

The horizontal line across the middle of the chart shows the bond value of the convertible, which doesn't change with movement in the price of the underlying stock.

The curved line above the shaded area shows the fair value of the convertible. The curved line gets closer to the parity line as the stock price goes higher, because the issuing company may call the convertible sooner. The curve starts falling below the bond value as the stock approaches zero, reflecting the correlation between increased default risk and a declining stock price.

As the chart title indicates, convertible pricing becomes more sensitive to equity values the higher the equity price moves; as the bond price moves up significantly, it trades more like an equity, albeit with a better yield.

The sweet spot appears to be in the center of the chart, where the issue is between behaving like a bond and a stock. The questions for investors at this point center around the value of the optionality in the convertible, represented by the premium paid over both its pure stock and bond values and the lower yield it offers relative to that of a similar-maturity nonconvertible. Conning analyzes this based on our evaluation of the issuer's credit risk and the future price range (volatility) of its underlying stock price. This valuation is also affected by several factors including the bond's final maturity date and coupon rate, any call and/or put features, dividend outlook and treatment, and bond subordination and covenants.

Risk and Possible Rewards

Convertibles generally rank low in a company's capital structure, just above equity. For lower quality issues, the bond floor can decline with the stock in a bear market, making the analysis of the company's financial outlook, debt structure, and asset value critical. These are important considerations in determining the suitability for each client's portfolio and in valuing an issue's fair spread even when times are good.

The asset class poses other risks as well. Some 60% of convertibles are not rated, and only 20% are rated investment grade, limiting potential opportunities for those seeking high quality options. Unlike the investment grade corporate market, which generally requires ratings from two agencies, convertible issuers do not have to get a rating to a deal done. This may create opportunities for investors with credit analysis skills to find opportunities among unrated convertible securities.

In addition, convertibles' lower coupon rates may be a concern for income-focused investors. Yields to maturity can appear odd to those unfamiliar with the asset class, particularly since many convertibles have bond-call features which force a very quick amortization of any premium in price. Conning focuses on current yield (coupon divided by price), which looks at convertibles like you would look at the dividend yield on a stock. Given that higher-priced convertibles trade there due to equity appreciation, the assumption that the price will go back down to par is not as relevant as it is for a fixed-income instrument.

Non-U.S. companies have started issuing more dollar-pay convertibles, giving investors more opportunities. This has served to improve the diversification benefits in sectors and names in addition to geographic factors. Non-U.S. companies have provided a number of higher quality investment-grade names that are particularly beneficial to U.S. portfolios.

Looking ahead, while more than half the annual convertibles issuance is unrated, investors may soon find more opportunities. Historical issuance has been on the rise recently and issuers can be expected to switch to more equity and convertible issuance due to the 2017 tax bill's increase in companies' after-tax debt cost of capital. In addition to lower tax rates reducing the "tax shield" which caused a lower after-tax debt cost of capital, the Tax Reform and Jobs Act of 2017 includes provisions that have reduced the amount of debt interest that can be written off, further encouraging companies to reduce their interest expense, an opportunity that convertibles can help with.

Conclusion

Convertibles provide insurers with a capital efficient way to structure their portfolios in uncertain economic environments. As interest rates rise, stock prices are likely to rise too, producing gains on convertible holdings in a time period when a typical fixed income portfolio will be losing value. Should interest rates again turn lower, current yields on convertibles are competitive with U.S. Treasury yields, minimizing lost income even if there is not much benefit from equity price appreciation. And, if equity prices fall, the fixed income component of convertibles will provide a floor valuation to protect investors' capital.

The asset's dual roles as both a fixed income asset and equity opportunity suggest a heightened level of complexity. An experienced manager well versed in the asset class as well as in the unique needs of insurance companies can add significant value to a convertible investment strategy.

Indices used on page 1

ICE BofAML Investment-Grade Convertible Index (ex Mandatories) – An index weighted by the market value (capitalization weighted) of the convertible issues in Bank of America Merrill Lynch's US convertible universe that have an investment grade rating (BAA3/BBB- or better) from either Standard & Poor's (S&P) or Moody's. The index includes investment grade convertible securities of U.S. corporations, including convertible bonds (coupon paying and zero coupon) and convertible preferreds, and includes issues sold under Rule 144A. It does not include Mandatory Convertibles which are issues that have limited appreciation potential with the underlying stock and do not have much fixed income value to cushion declines in the underlying stock – opposite of the characteristics of traditional convertibles.

ICE BofAML All Convertible Index (ex Mandatories) – A capitalization weighted index of all the convertible issues in Bank of America Merrill Lynch's US convertible universe except those that are considered mandatory securities. The index includes investment grade convertible securities of U.S. corporations, including convertible bonds (coupon paying and zero coupon) and convertible preferreds, includes issues sold under Rule 144A, and includes issues which have not been rated by either S&P or Moody's.

ICE BofAML Speculative-Grade Convertible Index (ex Mandatories) – A capitalization weighted index of all the convertible issues in Bank of America Merrill Lynch's US convertible universe except those that are considered mandatory securities that have a rating from S&P and Moody's of less than BAA3/BBB-. The index includes convertible securities of U.S. corporations, including convertible bonds (coupon paying and zero coupon) and convertible preferreds, includes issues sold under Rule 144A, but does not include issues which have not been rated by either S&P or Moody's.

Bloomberg Barclays US Aggregate Index – Barclays calculates their index on a capitalization weighted basis for investment grade rated government, corporate, mortgage pass-through, asset backed and commercial mortgage backed securities with at least \$250 million par value and more than one year until maturity. They use ratings from Moody's, S&P, and Fitch with the median used if all three rate it, the lower rating if only rated by two, and the sole rating if only rated by one rating agency. All issues must be SEC registered, taxable, US dollar denominated, and have a fixed coupon.

Bloomberg Barclays US 1-3 Month Short Term Government/Corporate Index – A capitalization weighted index of Issues with less than 3 months to maturity that have been taken out of the Barclays US Aggregate Index when they have less than one year to maturity.

Russell 2000 Index – A capitalization weighted index of the smallest 2000 stocks in the Russell 3000 index. The Russell indices are chosen by the Frank Russell company to include the largest 3000 issuers in the US.

Standard & Poor's (S&P) 500 Index – A capitalization weighted index of 500 US stocks. The index composition is managed by Standard & Poor's but is generally viewed as including the largest capitalization US stocks.

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* InsuranceRisk Best Economic Scenario Generator Software, 2011, 2013 & 2014; Asia Asset Management Magazine Best Risk Management Technology 2014; Risk.net ESG Buy-Side Award 2016; Insurance ERM Best Stress Testing & Scenario Solution, 2017.

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Indices used on page 1 (continued)

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