INSIGHTS & PERSPECTIVES

from MacKay Shields Convertibles Team

JUNE 2022

Convertibles 2022 Mid-Year Outlook

Inflation

Inflation was indeed the focus of the market and the Fed in the first half of the year. The Fed gave up on the term "transitory". In June the Fed raised rates by 75 basis points, one of the biggest increases in years. An attraction of of converts is that they historically are negatively correlated with interest rates. In a rising rate environment converts can still perform relatively well. For most of the year the market wrestled with the question of whether the Fed can slow inflation without causing a recession. Markets perform poorly during periods of uncertainty and have had a difficult first half. Our strategy employs a bottom up approach which focuses on the free cash flow of the issuer. Companies with good cash flow are better prepared to weather an economic downturn and are less volatile. This process has helped us to weather the market's weakness, at least on a relative basis.

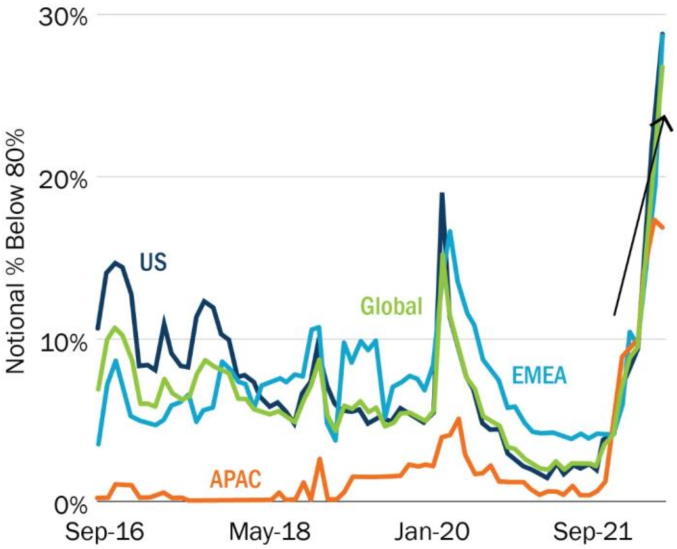
Valuation and New Issuance of Converts

Part of the reason the market's correction has been so severe is that many stocks entered the year with excessive valuations. Unfortunately, many of these companies also have converts and they have performed poorly. In fact, many of these companies issued their converts in the flood of issuance that the market has seen over the last 2 years. Looking back, we believe this hurt the convertible market's performance. Looking forward, we believe the poor performance of these converts creates an opportunity. A lot of these converts are now trading at 70 or 80 cents on the dollar. Usually companies whose bonds are trading at these levels are distressed. We do not believe this is the case with many of these these converts. Our research indicates many of these companies' fundamentals are intact; rather, the bonds are at these prices because the companies issued the converts when their stocks were overvalued. The converts are now close to bond value which means a further decline in the stock will likely have little impact on the price of the bond. Meanwhile these bonds offer attractive yields to maturity and offer the opportunity to participate in the stock's recovery. From these levels we believe these converts should provide favorable asymmetry of returns in that holders can capture more of the upside if the stock rises than the downside if the stock declines. Furthermore, many of these companies are in the technology sector, a sector that is largely not available in the high yield market.

Asymmetry of Returns

Capturing the asymmetry of returns afforded by convertibles is an important part of our strategy. Usually the best way to implement this component of our strategy is to buy the convert when it is issued at par. At par the convert is balanced and the holder can expect to capture 60-70% of the upside if the stock were to rise while only participating in 40-50% of the downside[1]. With the rise in rates we expect more companies will be coming to market and issuing converts. Issuing a convert allows a company to pay a coupon that is lower than if the company had issued a straight bond. Furthermore as the rate differential rises between convertibles and straight bonds the quality of companies issuing converts will likely improve.

FIGURE 1: NUMBER OF CONVERTS TRADING BELOW 80 CENTS ON THE DOLLAR



As of June 30, 2022
Source: BofA Global Research, ICE Data Indices, LLC

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1. Based on historical index returns. It is not possible to invest directly in an index. Past performance is not indicative of future results.