INSIGHTS & PERSPECTIVES
from MacKay Shields Convertibles Team

MACKAY SHIELDS
A NEW YORK LIFE INVESTMENTS COMPANY

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Convertibles: Why Now?

At 2% of the US investment-grade market and 15% of the US high yield market, US convertibles are often overlooked by investors. But recent asset class growth and structural dynamics suggest that investors should consider US convertibles, especially in rising rate and inflationary environments.

Recent poor performance versus equity and high yield asset classes suggest that now may be an attractive entry point for investors. Many recently issued convertible bonds are trading below 90, in some cases very close to their theoretical bond floors, with yields-to-maturity of 2% to 7%. Investors can choose either a broad market allocation or a low-delta allocation, depending on their risk preference.

Understanding Recent Convertible Market Performance

Historically, U.S. convertible securities have offered an attractive risk/return profile. From 1988 through 2021, the ICE BofA U.S. Convertible Index captured about 80% of the upside and 60% of the downside of the average rolling 12-month returns of the S&P 500, NASDAQ Composite, and Russell 2000 indices.[1] Even when the S&P 500 exceeded or declined by more than 10% in any given quarter, convertibles continued to exhibit asymmetric returns relative to equities (Figure 1). Recent relative performance has been weaker. In 2021, the three equity indices rose 28.7%, 22.2%, and 14.8%, respectively, for a 21.9% average return; the convertible index returned 6.3%, or 29% of the equity indices' average. Year-to-date through April 2022 downturn, the average return for these three equity indices was (16.9)%, while convertibles returned (12.1)%, participating in about 72% of the decline.

Convertibles had particularly poor performance relative to the S&P 500 for several reasons (Figure 2). The best-performing

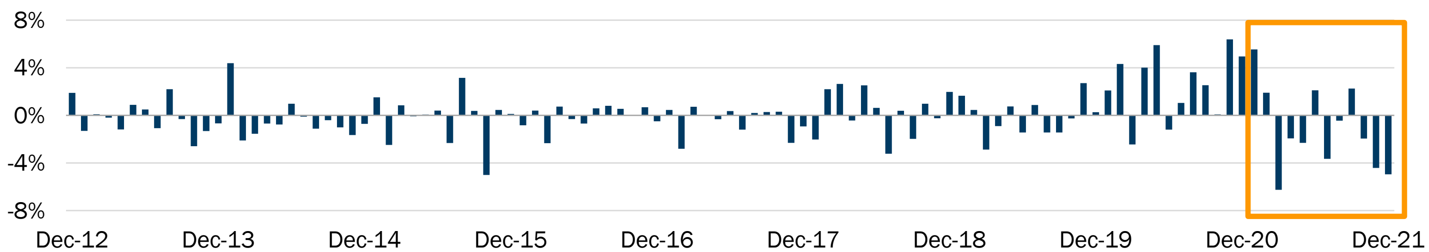
FIGURE 1: ASYMMETRIC RETURNS FOR CONVERTIBLES 1988-2021[2]

	Average Quarterly Returns			
	Preferred	High Yield	Convertible	S&P 500
S&P 500 > 10%	4.8%	6.7%	11.3%	13.7%
% of Capture	*35%*	*49%*	*82%*	
S&P 500 <(10)%	(2.2)%	(4.7)%	(8.6)%	(14.8)%
% of Capture	*15%*	*32%*	*58%*	

Source: Bloomberg, ICE Data. Indices are ICE BofA Fixed Rate Preferred Securities Index, ICE BofA U.S. High Yield Index, ICE BofA U.S. Convertible Index.

FIGURE 2: CONVERTIBLES UNDERPERFORMED IN 2021

Convertible Bonds Underlying Equity Returns Minus S&P 500 Monthly Returns from 2012-2021



Source: MacKay Shields, Bloomberg, ICE Data.

1. Based on internal calculations comparing the rolling 12-month returns of the ICE BofA U.S. Convertible Index with the equal weighted average of the S&P 500, NASDAQ Composite, and Russell 2000 indices between 1988-2021.
2. Percentage capture determined based on average quarterly returns. Average quarterly returns calculated based on the relevant asset class' performance in each calendar quarter where the S&P exceeded +10% or declined more than (10)%.
It is not possible to invest directly in an index. Please see disclosures at the end of this document for important benchmark information, including disclosures related to comparisons to an index and index descriptions. **Past performance is not indicative of future results.**

sectors in the S&P 500, such as Energy and Materials, have a very low representation in the convertible benchmark. In addition, the mega-cap companies that performed exceptionally well in 2021, such as Apple, Microsoft, and Alphabet, have no representation at all in the convertible market.

Convertibles Look Attractive vs. Other Debt Instruments

We think investors should view convertibles as an alternative slice of their bond allocation. Unlike straight bonds. convertibles historically have a negative correlation to interest rates, because convertible bond performance is largely driven by the performance of the issuer's equity. In periods when interest rates and inflation rise, equities tend to advance in tandem with corporate profits. Also, convertibles do not necessarily mature at their nominal $1,000 par value. If the underlying equity rises above the bond's conversion price, the bond can be converted into cash or common stock worth more than the bond's par value. Owning a fixed-income security with performance relatively independent of interest rates and with capital appreciation potential may be an advantage in the current market environment (Figure 3 below and Figure 4 on the following page).

The sharp selloff in the stocks of many companies in 2021 that had recently issued convertible bonds has created an attractive opportunity for convertible investors, in our view. Many of these bonds are now trading below 90, in some cases very close to their theoretical bond floors, and many offer yields to maturity of 2% to 7%. These bonds are not "busted," (their imbedded call options are not worthless), so there exists the capital appreciation potential if the underling share price recovers. For example, the convertible bonds of a game developer were trading near 90 recently. When the issuer announced it was being acquired, the bonds rose to 102.

Convertible bonds trading close to their theoretical bond floors pose relatively little downside risk, unless the company becomes financially distressed or interest rates rise significantly. Since most of these convertible securities are notes that mature in two to five years, their interest rate risk is relatively low. One downside, however, is that most of these instruments were issued with minimal cash coupons and their current cash yields are generally very low or nonexistent, even if their yields-to-maturity are attractive.

FIGURE 3: CONVERTIBLES BONDS HISTORICALLY RESILIENT TO INFLATION (TOTAL RETURNS: 1973-2021)

	Average CPI	Peak CPI	Aggregate	Convertibles	S&P 500
JAN 73 - DEC 77	7.7%	12.3%	7.0%	6.8%	0.2%
JAN 78 - DEC 82	9.8%	14.8%	8.4%	16.5%	14.1%
JAN 87 - DEC 91	4.4%	6.3%	9.9%	8.7%	15.4%
FEB 98 – JAN 01	2.4%	3.8%	6.7%	12.3%	10.9%
JUN 05 – SEP 08	3.5%	5.6%	3.6%	0.2%	1.3%
MAY 20 – DEC 21	3.4%	7.0%	0.2%	30.4%	34.7%

Source: Bureau of Labor Statistics, Advent Capital Management (Convertibles for Jan 73-Dec 77, Jan 78-Dec 82, Jan 87-Dec 91 (used with permission), Bloomberg, ICE Data. Aggregate = Bloomberg U.S. Aggregate Index and Convertibles = ICE BofA U.S. Convertible Index.

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FIGURE 4: ASSET CLASS PERFORMANCE IN RISING INTEREST RATE ENVIRONMENTS

Periods Where 10Yr Treasury Yield Increased by 1% or Greater								
Period		Change in 10Yr Yield	Aggregate	Investment Grade	Preferreds	High Yield	Convertible	S&P 500
JUL-89	APR-90	1.2	1.0%	0.3%	(3.9)%	(5.0)%	(3.5)%	(2.0)%
SEP-93	NOV-94	2.5	(3.5)%	(4.3)%	(5.9)%	1.4%	(4.8)%	2.2%
DEC-95	AUG-96	1.4	(1.1)%	(2.2)%	3.1%	4.8%	8.2%	7.5%
SEP-98	JAN-00	2.3	(0.8)%	(1.3)%	(0.5)%	4.9%	62.0%	39.4%
OCT-01	MAR-02	1.2	(1.9)%	(2.0)%	1.2%	4.5%	4.9%	8.9%
MAY-03	JUN-06	1.8	6.1%	6.4%	9.3%	31.2%	25.7%	39.3%
DEC-08	DEC-09	1.6	5.9%	19.8%	20.1%	57.5%	47.2%	26.5%
AUG-10	MAR-11	1.0	(0.8)%	0.0%	5.2%	10.3%	19.5%	27.8%
JULY-12	DEC-13	1.6	(1.6)%	0.9%	(1.5)%	13.8%	33.0%	38.3%
JULY-16	OCT-18	1.7	(2.1)%	(0.2)%	4.6%	13.6%	26.7%	30.5%
Average		**1.6**	**0.1%**	**1.7%**	**3.2%**	**13.7%**	**21.9%**	**21.8%**

Source: Bloomberg, ICE Data. Aggregate = Bloomberg U.S. Aggregate Index, Investment Grade = ICE BofA US Corporate Index, Preferreds = ICE BofA Fixed Rate Preferred Securities Index, High Yield = ICE BofA U.S. High Yield Index, and Convertible = ICE BofA U.S. Convertibles Index.

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Adding convertible bonds to a traditional fixed income portfolio also offers the benefit of exposure to sectors, such as Information Technology and Healthcare, with large weightings in the convertible universe but little or no weight in most fixed-income benchmarks.

While convertible bonds are usually the most volatile of fixed income securities, recent market dynamics may give investors an opportunity to capture potential favorable returns relative to other debt instruments.

MacKay's Approach to US Convertibles

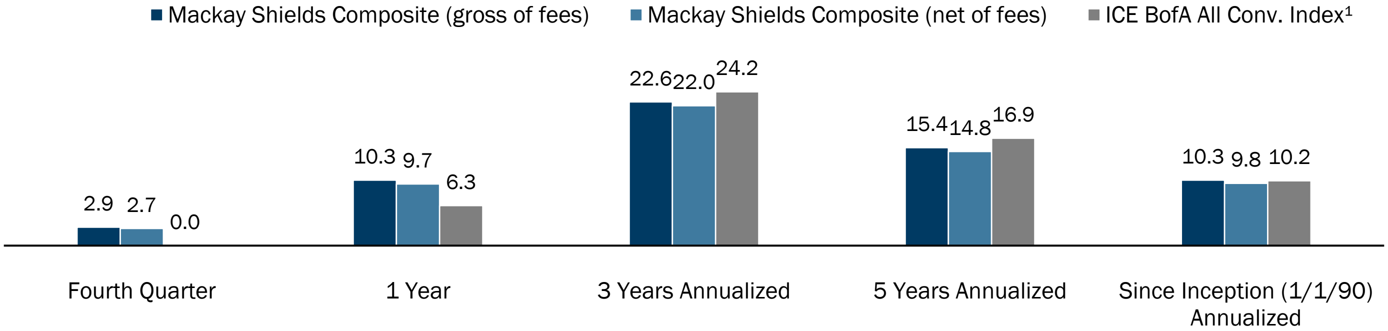
Since it's inception, MacKay's Convertible team has sought long-term fundamental value in actively managed portfolios. We largely own securities that we believe offer a measure of downside protection, issued by companies with strong business models whose underlying equities trade at reasonable valuations based on prospective free cash flow. The strategy generally has not fared well in speculative environments, when momentum and hype drove convertible performance. Fortunately, such markets are infrequent and generally short-lived: They have prevailed at least twice in the last quarter century, in the late 1990's and in 2020. Our strategy's relative performance was poor in both periods, and rebounded when the market corrected.

In 2000, the MacKay Convertibles strategy returned 3.8% after fees and 4.3% gross, while the convertible index returned (10)%. In 2021, the MacKay Convertibles strategy outperformed in each quarter, generating an annual return of 9.7% after fees and 10.3% gross, while the Convertible Index returned 6.3%.[3] Relative to peers, the strategy was top quartile for one-year returns.[4]

We don't expect a correction ahead comparable to 2000, but we do think the market is likely to continue to favor securities with sound fundamentals and reasonable valuations when interest rates are no longer kept near zero and crowds of online speculators no longer divorce a company's share price from its earnings prospects. We believe our strategy's strong results in 2021 demonstrate the soundness of our investment approach in a market where valuations once again matter.

3. Please see the GIPS-compliant composite performance page in this document for additional performance information and disclosures.
4. Based on eVestment's US Convertible Bond Universe.

Composite Returns (%) | Period Ending December 31, 2021



Composite Disclosures

Period	MacKay Shields Composite Gross Returns (%)	MacKay Shields Composite Net Returns (%)	ICE BofA All Conv. Index[1] Returns (%)	Composite 3-Yr St Dev (%)	Benchmark[1] 3-Yr St Dev (%)	No. of Accts.	Composite Assets ($Mil)	Firm Assets ($Mil)	Internal Dispersion (%)
2021	10.3	9.7	6.3	14.4	16.3	12	4,211	163,646	0.7
2020	35.9	35.3	46.2	15.5	16.7	13	3,548	153,995	3.3
2019	23.0	22.4	23.2	9.1	8.3	15	3,196	131,978	1.8
2018	-1.4	-1.8	0.2	9.0	8.2	11	2,405	107,467	1.0
2017	12.6	12.1	13.7	8.3	7.7	13	2,377	98,098	1.2
2016	12.0	11.4	10.4	8.9	8.7	17	1,967	94,540	1.2
2015	-0.3	-0.8	-3.0	7.9	8.1	16	1,811	89,196	0.9
2014	9.2	8.6	9.4	7.4	7.6	12	2,069	91,626	1.4
2013	24.4	23.8	24.9	10.7	9.5	7	1,934	80,331	2.9
2012	9.7	9.2	15.0	12.3	10.7	8	1,577	78,371	0.9

1. ICE BofA All Convertibles Index

The Convertible Composite includes all discretionary convertible accounts managed with similar objectives for a full month, including those accounts no longer with the firm. This strategy primarily consists of convertible securities such as bonds, debentures, corporate notes, and preferred stocks or other securities that are convertible into common stock or the cash value of a stock or a basket or index of equity securities. The strategy may invest in debt securities that are rated investment grade and below investment grade or, if unrated, that we determine to be of equivalent quality. Gross-of-fees composite performance reflects reinvestment of income and dividends and is a market-weighted average of the time-weighted return, before advisory fees and related expenses, of each account for the period since inception. Net-of-fees composite performance is derived by reducing the quarterly gross-of-fees composite returns by 0.125%, our highest quarterly fee. Policies for valuing investments, calculating performance, and preparing GIPS reports are available upon request. GIPS® is a registered trademark of CFA Institute. CFA Institute does not endorse or promote this organization, nor does it warrant the accuracy or quality of the content contained herein. Performance is expressed in US Dollars. The composite inception date is 1/1/90. The composite creation date is 1/1/01. All portfolios in the composite are fee-paying portfolios. There can be no assurance that the rate of return for any account within a composite will be the same as that of the composite presented. **Past performance is not indicative of future results.**

MacKay Shields LLC, an SEC-registered investment adviser, claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. The firm has been independently verified from January 1, 1988 through December 31, 2020. The verification report is available upon request. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. Verification does not provide assurance on the accuracy of any specific performance report. A list including composite descriptions, pooled fund descriptions for limited distribution pooled funds, and broad distribution funds is available upon request. The primary benchmark for this composite is the ICE BofA All Convertibles Index. The CS First Boston Convertible Index was the primary benchmark for this product until 1/1/05. It was removed because CS First Boston ceased publication of this index. Indices do not incur management fees, transaction costs or other operating expenses. Investments cannot be made directly into an index. The ICE BofA All Convertibles Index is referred to for comparative purposes only and is not intended to parallel the risk or investment style of the portfolios in the MacKay Shields Composite. Internal dispersion is calculated using the equal-weighted standard deviation of annual gross returns of those portfolios that were included in the composite for the entire year. The three-year annualized standard deviation measures the variability of the composite gross returns and the index returns over the preceding 36-month period.

IMPORTANT DISCLOSURE

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INDEX DEFINITIONS

The **ICE BofA All U.S. Convertibles Index** is an unmanaged index that consists of convertible bonds traded in the U.S. dollar denominated investment grade and non-investment grade convertible securities sold into the U.S. market and publicly traded in the United States. The Index constituents are market value weighted based on the convertible securities prices and outstanding shares, and the underlying index is rebalanced daily.

The **NASDAQ Index** is an unmanaged market-capitalization weighted index of the more than 3,000 common equities listed on Nasdaq stock exchange.

The **S&P 500 Index** is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

The **Russell 3000 Index** is an unmanaged and market capitalization weighted equity index maintained by the Russell Investment Group that seeks to be a benchmark of the entire U.S. stock market. More specifically, this index encompasses the 3,000 largest U.S.-traded stocks, in which the underlying companies are all incorporated in the U.S.

The **ICE BofA U.S. High Yield Index** tracks the performance of U.S. dollar-denominated below investment-grade corporate debt publicly issued in the U.S. domestic market.

The **ICE BofA Fixed Rate Preferred Securities Index** The ICE BofA Fixed Rate Preferred Securities Index tracks the performance of fixed rate, U.S. dollar denominated, investment-grade preferred securities in the U.S. domestic market.

The **Bloomberg U.S. Aggregate Index** is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-through), ABS and CMBS (agency and non-agency).
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