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Beyond Bulls & Bears

EQUITY

# Thoughts on Investing in Convertible Securities

May 7, 2014

Changes and potential changes in monetary policy across the globe, along with increased volatility in currency and equity markets, have thrown a spotlight on convertible securities, described by some as offering the "best of both worlds" in terms of stock and bond characteristics. But what are they, how do they work, and how can they play a part in a diversified investment portfolio in today's market? Alan Muschott, portfolio manager for Franklin Convertible Securities Fund, who has been investing in convertible securities for more than a decade, provides his take.

Monetary policy around the globe has been shifting visibly away from the ultra-accommodative approach that began during the 2008–2009 financial crisis, and many observers now believe interest-rate risk may be on the rise. Meanwhile, rising geopolitical tensions threaten to increase volatility in global currency and equity markets. So it is not surprising that investors would look for ways to reduce their downside risk from exposure to the effects of the changing interest rate outlook on equities, bonds and foreign currencies.

In an attempt to achieve that goal, some investors have turned to convertible securities. Issued by companies looking to raise capital, these are hybrid instruments that can be structured as either debt—such as bonds, notes or subordinated debentures—or as some form of equity, such as preferred shares. Owning a convertible gives the holder the right to convert it into a certain number of shares of a company's underlying stock under predetermined conditions.

Convertibles can offer participation in the capital appreciation potential of common stocks while the bond component provides interest payments and a claim to principal. If a company's common stock rises, the convertible security should increase in value because of the price relationship with the common stock. If the common stock doesn't perform well, the bond component should help soften the potential downside. In an environment of above-average market volatility, convertibles may be attractive investments because they are typically expected to help protect against potential erosion of value in declining markets while still allowing for participation in equity appreciation if markets move higher. [perfect_quotes id="3180″]

I'm often asked about the performance of convertibles in rising rate environments, particularly given the increase we've seen in the 10-year Treasury yield over the past year. If rates are rising for the right reasons—the economy is improving and getting stronger—then we're also likely to be in an environment of corporate earnings growth and a generally positive outlook for equities overall. While there would likely be a general loss of value due to the increase in rates from the fixed income component, we have often found that, in this environment, the increasing value of the option to convert to equity tends to more than compensate for this. So I believe that convertibles could generally perform well in a rising rate environment.

While convertible securities have exhibited a range of correlations across asset classes, historically, they have been highly correlated with equities and negatively correlated with US Treasuries.[1] Within the fixed income category, convertibles behave most like corporate bonds, especially high-yield corporate bonds, because based on our experience, they tend to move more with the fundamentals of the company.

### Focusing on Balanced Convertibles

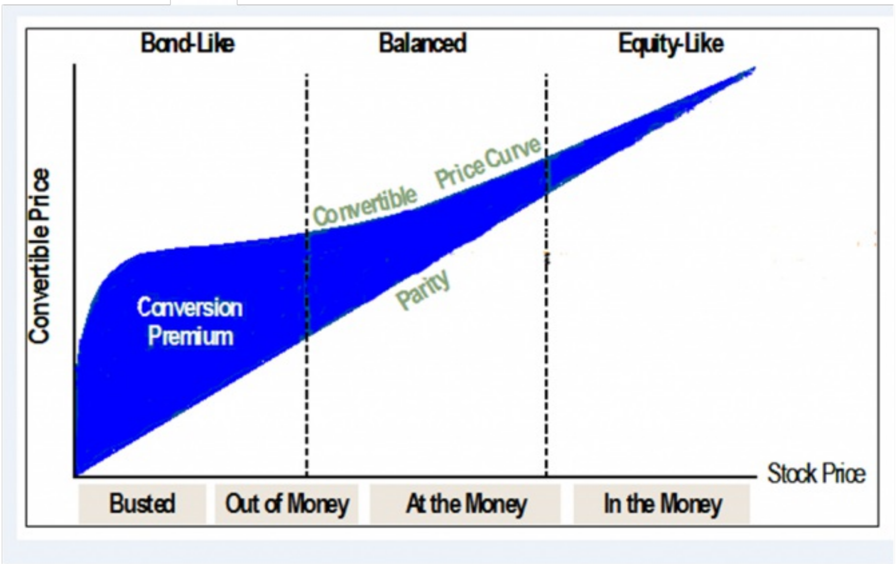
Globally, there is a large and diverse universe of convertibles for investors to choose from. Companies of all sizes, from all sectors, and with a full range of credit rating characteristics have been issuing them for years. Their reasons for issuing convertibles include a potential lower cost in terms of interest payments rather than straight debt and less potential dilution to their outstanding common shares than new equity. They can also help companies diversify their funding sources with their appeal to a wider range of investors.

Generally speaking, convertibles can be categorized into three primary groups. The most bond-like convertibles are called “busted” convertibles because the price at which the security would convert is substantially greater than the equity price. This tends to discourage the conversion, making these convertibles less sensitive to movements in the underlying common stock price. This type of convertible provides income, which will offset price declines due to stock market weakness, but offers limited participation in capital appreciation should the underlying equity rally.

At the other end of the spectrum are “equity-like” convertibles, in which the conversion price is equal to or less than the underlying equity price. Typically, performance of these securities closely tracks the underlying stock, exposing investors to nearly the same level of volatility as the shares to which they are linked, though retaining the potential income and the principal security of a bond.

Occupying the middle ground between these two types are so-called “balanced convertibles” that offer a moderate level of conversion premium and share price sensitivity. We believe one of their advantages is their “asymmetric” risk/return profile that can result in greater potential participation in the upside performance of the underlying common stock and lower participation in any decline in its value. Because of their asymmetric risk/return profile, we tend to favor balanced convertibles in our strategy.

**Types of Convertible Securities**

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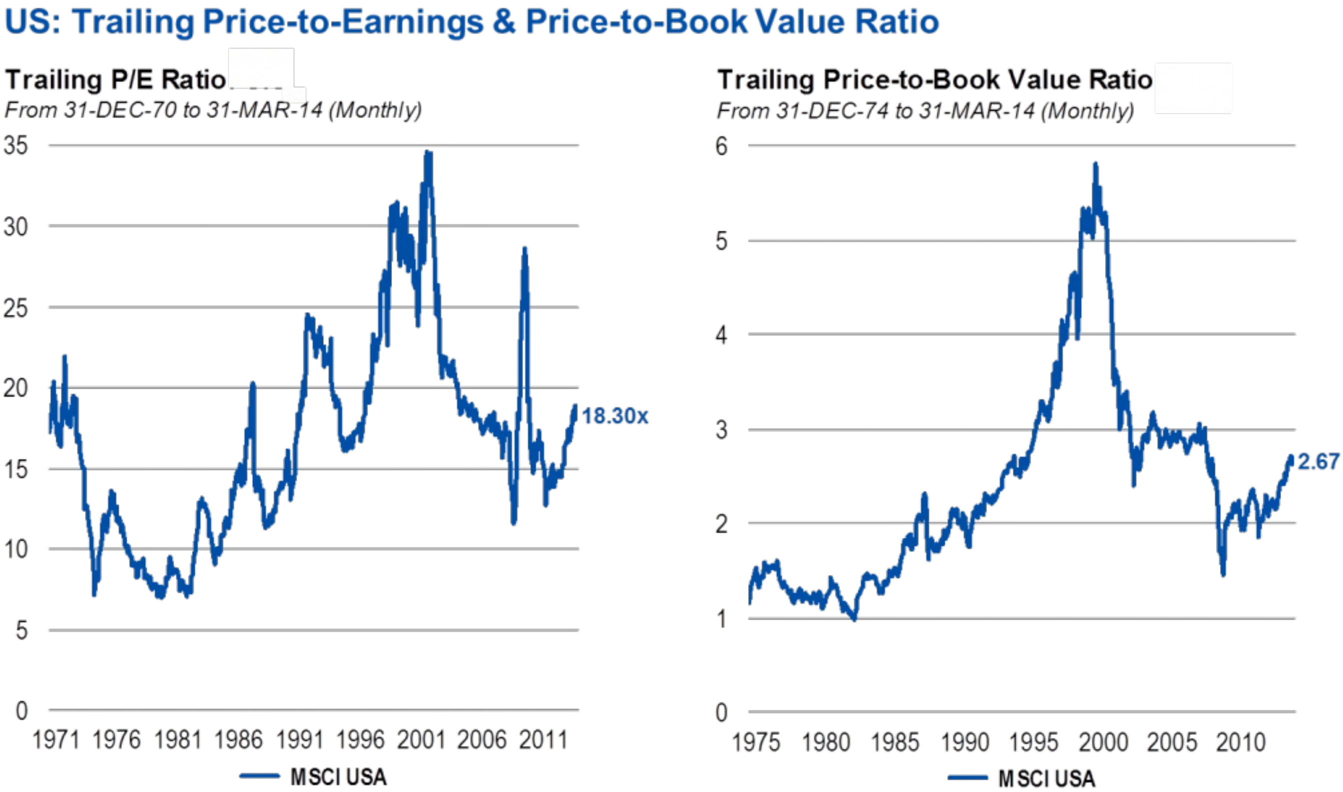
Source: Franklin Templeton Investments.

## Constructive Outlook in Uncertain Environment

Looking at the global macro-political environment today, investors may be worried about the tension between the West and Russia over Ukraine and the sustainability of gains in a number of global equity markets. In Europe, equity market appreciation has been significant since 2012, while the US equity market has seen a sustained run-up over the last five years. The US and European economies appear to be improving, with companies in both regions growing earnings. But unemployment has so far been coming down, mostly in the United States. Meanwhile, equity market valuations in both regions are still below their long-term averages, so there's a balance of risks, in our view.

Currently, we have a constructive outlook for the US equity market. And, we believe valuations are generally reasonable, tracking long-term averages.

With these different factors at play, we think there are reasons to be optimistic yet cautious. Thus, we believe holding convertibles in the current environment could be attractive as part of a balanced portfolio for many investors.

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### What Are the Risks?

**Franklin Convertible Securities Fund**

All investments involve risks, including possible loss of principal. The fund may invest in high-yielding, fixed income securities. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Interest-rate movements may affect the fund's share price and yield. Bond prices generally move in the opposite direction of interest rates. As the prices of bonds in the fund adjust to a rise in interest rates, the fund's share price may decline. The fund may also invest in foreign securities, which involve special risks, including political uncertainty and currency volatility. These and other risk considerations are discussed in the fund's prospectus.

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1. Treasuries, if held to maturity, offer a fixed rate of return and fixed principal value; their interest payments and principal are guaranteed.

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