ALTERNATIVES

Driving a Case for Convertibles in 2017

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When many people hear the word “convertible,” carefree driving, sunny roads and wind-blown hair probably come to mind. Franklin Equity Group Portfolio Manager Alan Muschott thinks of convertibles as something entirely different. He sees an investment vehicle, and one that doesn’t represent reckless abandon, but rather, one that can offer attractive yields to income-seeking investors as well as an asymmetric risk/reward profile. Here, he makes the case for why investors might consider convertible securities in the coming year, particularly as US interest rates look set to continue rising and many global uncertainties remain.

Those looking back at 2016 may be surprised to find a lack of volatility as markets generally took in stride both the United Kingdom’s vote to leave the European Union (known as Brexit) and the surprise election of Donald Trump as the next president of the United States. As equity markets—particularly in the United States—moved higher, global interest rates remained historically low, with negative government bond yields in Germany, Japan and Switzerland making headlines. This may change in 2017, however.

Impact of Rising Rates

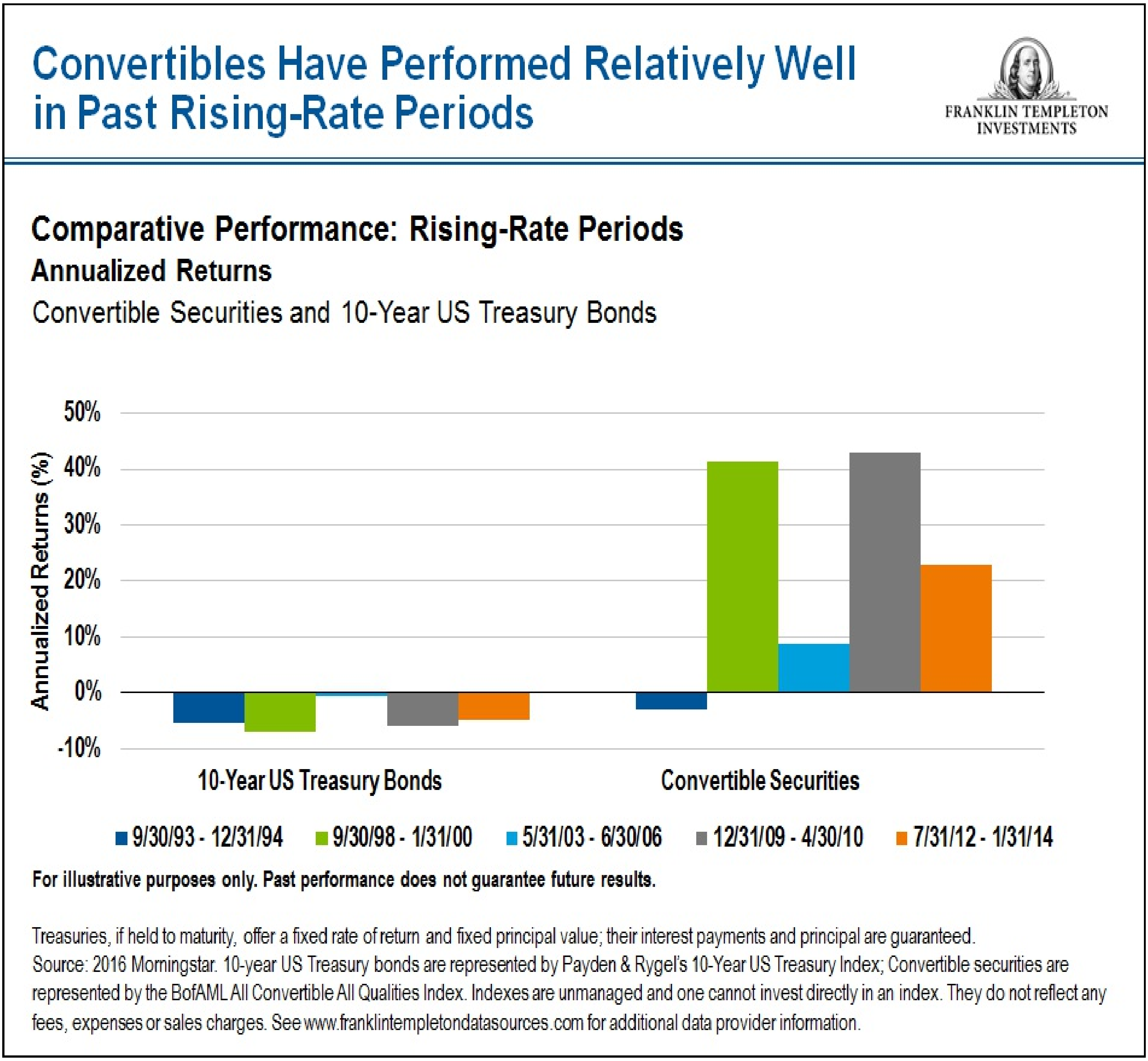
Even if we do not see a general paradigm shift toward widespread rising interest rates globally, rates can rise suddenly and strongly, taking the markets by surprise. When that happens, traditional government and corporate bonds face losses, and the potential losses are typically higher for bonds with longer maturities. This risk is expressed as duration risk—the measure of a fixed income instrument’s sensitivity to changes in interest rates.

What Is a Convertible Bond?

Issued by companies looking to raise capital, a convertible bond is a type of bond that the holder can convert into a specified number of shares of common stock in the company under predetermined conditions. Convertible bonds offer a fixed income component in the form of coupon payments (the interest rate paid on a bond) as well as potential to benefit from a rise in the stock’s share price through the conversion to equity. If a company’s common stock rises, the convertible security should increase in value because of its price relationship with the common stock. If the common stock doesn’t perform well, the bond component should help soften the potential downside.

Corporate treasurers have taken the opportunity in recent months and years to refinance and increase debt loads in an environment of low interest rates. Overall, duration risk is significantly higher for conventional bonds compared to convertible bonds. Many convertibles are issued with a maturity of three to five years, either maturing as a traditional bond or converting to equity. Additionally, if the underlying equities are performing well, the associated convertible securities should trade based on their conversion value rather than their bond characteristics.

In the last few decades, there have been five periods of rising rates and corresponding negative returns for government bonds. These periods differed in length and magnitude, but they had one characteristic in common: although convertible bond performance was not always positive, convertible bonds performed relatively well compared with government bonds. (See chart below.)



In our view, 2017 could be a year where the properties of convertibles become an increasingly important feature for investors' asset allocation. We expect to see an environment supportive of equity markets, driven by a general shift from expansive monetary policy to expansive fiscal policies—and not only in the United States. In this environment, we think a well-structured convertible bond strategy with the goal of participating in a majority of the underlying equities' upside, and less of the underlying equities' downside, offers investors an attractive risk-reward investment option.

We think the potential advantages of investing in convertibles are compelling: relatively low duration risk, participation in the potential appreciation of the underlying equities (allowing for a built-in inflation adjustment), and potential to mitigate downside movements in equities. We continue to believe numerous secular growth themes offer multiple opportunities.

We take an active-management approach focused on “balanced” convertibles that tread the middle ground between equity- and bond-like characteristics, and that offer a moderate level of conversion premium and equity sensitivity. One of their typical primary advantages is an asymmetric risk/return profile, which can result in greater potential for participation in the upside return of the underlying stock and lower participation in the stock’s downside.

Finding Value

At Franklin Equity Group, our portfolio managers and analysts are focused foremost on understanding the fundamentals and financial health of individual companies. This bottom-up research singles out firms that are capitalizing on or driving multi-year growth trends, because we believe such business models can foster superior profitability over the long term.

Looking at opportunities across sectors, we see technology as increasingly becoming a non-discretionary expense for a wide range of companies and industries. Third-party providers stand to benefit from these trends as such firms often lack the expertise, personnel and resources to develop technology in-house.

Within global equity markets, “bond proxies”—companies perceived as safe and defensive, offering reliable dividends, and often in sectors like consumer staples and utilities—generally have become historically expensive in 2016, despite their recent selloffs. We are finding some selectively better values in dynamic sectors like health care and information technology, in which long-term innovation and growth are being undervalued, in our assessment.

Navigating Change and Volatility

Ultimately, markets may remain driven by monetary policy for some time, amplifying our concern about the dwindling number of rational capital allocators in the global financial system. Capital should flow to where it can expect to achieve the best return; we believe price-insensitive government buyers and fundamentally agnostic index investors are not fulfilling this critical role. The rising share of capital being invested in these ways has contributed to a growing correlation between the returns of different financial assets. Over time, we expect these imbalances to correct, potentially impairing misallocated capital while benefiting investors who have maintained the discipline of investing in fundamentally undervalued securities through the cycle.

Navigating changes in financial markets is never easy. While the global financial system today seems to be far better equipped to deal with systemic crisis than it was in 2008, we nevertheless expect periods of instability and volatility as China’s economy continues to transition, post-election uncertainty lingers in the United States and the populist forces that drove the Brexit vote struggle for ascendancy in various parts of the world. We are confident that near-term pain could once again pave the way for long-term opportunity.

Looking forward, we believe convertible bonds continue to be an appealing option for income-focused investors looking to capture much (but not all) of equities’ upside potential but with less downside risk. Convertibles can also be attractive in low interest-rate environments when sources of income may be scarce.

Historically, convertibles have tended to perform well during periods of above-average market volatility, when cautious investors with a generally positive view of the equity markets seek risk-controlled equity exposure to reduce potential downside risk. Rising stock markets also tend to favor convertible securities due to the price linkage with the underlying common stock. We believe this ability to adapt to myriad market conditions makes convertibles an attractive vehicle for potentially increasing a portfolio’s level of diversification.

It also bears mentioning that within a company’s capital structure, convertible securities can be ranked at various levels of seniority, ranging from the most junior preferred stock to senior debt. Most convertibles are issued as senior unsecured debt, which ranks higher than stocks with respect to income distribution or liquidation.

Convertible Gaining Attention

Corporations seem to have grown more comfortable issuing convertible securities as an alternative means of financing by taking advantage of global market conditions that can potentially lower their overall cost of capital below what it would be if they issued only one class of debt and common stock.

Worldwide, convertible securities are garnering increasing attention from both issuers and investors. The asset class has ample room for expansion, in our view, as companies across the globe look for financing and endeavor to attract investors to their common shares at the lowest possible cost. Compared with a few years ago, issuers have been coming from an increasingly diverse mix of sectors, countries, industries and market-capitalization sizes, which has widened our potential investment universe. Because convertible bonds typically carry a lower coupon rate than straight debt due to their conversion option, they can be a more attractive option to companies in higher-rate environments. Should rates increase, we may see an increase in issuance in the convertibles space.

Using our consistent process that leverages a deep bench of research analysts who identify opportunities from a bottom-up perspective, we are finding companies with high-quality business models that we believe can capitalize on secular trends to create sustainable growth. As always, we look to invest in convertibles that offer an appealing yield, potentially attractive risk/reward profiles, and the potential for attractive long-term risk-adjusted return.

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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.

Investors should carefully consider a fund's investment goals, risks, charges and expenses before investing. To obtain a summary prospectus and/or prospectus, which contains this and other information, talk to your financial advisor, call us at (800) DIAL BEN/342-5236 or visit franklintempleton.com. Please carefully read a prospectus before you invest or send money.