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POLAR CAPITAL

Where do we go from here?

In this document, the Polar Capital Convertible team explore recent macroeconomic developments, the outlook for risk markets and how convertible bonds can fit into an investor's portfolio.

> "As equities rise, convertibles participate to an increasing degree, until they trade in lock-step with equities… as equities fall, the equity sensitivity of a convertible progressively falls towards zero"
>
> **David Keetley, Portfolio Manager**

Over the past year or so the macro environment has offered up a number of crosscurrents – the ongoing Russia/Ukraine war, Israel's conflict with Hamas and Hezbollah and political shifts in the UK, France and Japan, alongside government stimulus shifts in China.

More recently, the US election has resulted in a clean sweep for the Republicans across the executive and legislative branches, adding to the judicial branch which is arguably the most conservative-leaning in modern US history.

Against this backdrop, developed market equities have risen substantially. Indeed, in the year to 11 November 2024 (the time of writing), the S&P 500 hit a record high, appreciating by 35.9%, with valuations looking extended and forward P/Es as expensive now as they were during the pandemic. Equally, credit markets have performed strongly, with US high yield spreads tightening approximately 50bp year-to-date to sub-300bp.

As we take a step back, investors are asking: 'Where do we go from here?'.

Surveying the current backdrop, we continue to see competing crosscurrents. In the US, labour markets have remained solid with unemployment appearing to be under control, despite a rise from 3.8% to 4.1% over the past year. While a strong jobs market suggests economic resilience, if employment remains high, inflationary pressures could persist, potentially reducing the number of Fed cuts. For context, the Fed finished its latest round of interest rate hikes in July 2023, began cutting rates in September 2024 and is anticipated to continue to lower rates until late 2025 or possibly early 2026.

Moreover, Trump's picks for key administration posts have been hawks who seem likely to pursue the 'America first' policy. This is raising concerns over the growth impact in Europe and China, as well as inflation as tariffs seem likely to lower growth and raise inflation.

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Portfolio Manager
ALPHA MANAGER 2024 David Keetley
CITYWIRE +

David joined Polar Capital in October 2010 to establish the global convertibles team and is co-manager of the Global Convertible Strategy and the Global Absolute Return Strategy.

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Michael joined Polar Capital as an Investment Analyst in the Convertible Bond Team in July 2022.

In China, the size and effectiveness of government stimulus measures are under scrutiny. The government has unveiled a RMB10trn debt package to ease local government funding strains and stabilise faltering growth, but the scale of these efforts and their ability to successfully spur demand remain unclear and so far appear to have fallen somewhat short of investor expectations. It remains to be seen if more stimulus will be announced in 2025. A successful stimulus could lift not only the Chinese economy but also global trade. However, if it falls short, it may further dampen investor confidence and exacerbate fears about China's slowing growth, impacting emerging markets – as their closest trading partners – and companies with significant exposure to China.

In Europe, the economic outlook remains subdued, with sluggish growth and specific challenges such as strikes and disrupted productivity in Germany, the region's largest economy. Political uncertainties further complicate Europe's investment landscape. Germany's coalition government faces internal challenges, raising fears of a political breakdown; in France, political instability and shifts in policy add to concerns about the region's stability. For investors, Europe's weaker growth trajectory, compounded by domestic disruptions, poses questions about the potential for meaningful returns in European markets.

Japan's new government is also under the microscope, with questions around whether it will continue former Prime Minister Shinzo Abe's policies, including loose monetary policy. Investors are particularly focused on potential shifts toward normalising monetary policy, as any changes could affect the yen's strength and broader economic growth. For markets, the uncertainty around Japan's policy direction represents both potential risks and opportunities, depending on how the new government navigates these challenges.

On the corporate front, we have continued to see momentum in company earnings across multiple industries and geographies, alongside valuation support as interest rates have fallen, most notably for mega-cap US technology stocks and those companies that have been deemed AI beneficiaries.

So where do we go from here? We feel we are at something of a crossroads. On the one hand, following the rally of the past year, there is an argument that valuations look extended (S&P 500 Index: 6001, NASDAQ Composite Index: 19,299[1]), – with US high yield credit spreads sub-300bps (CDX HY spread 298bps[1]) and forward P/Es as expensive now as they were during the pandemic – especially as we move into a potentially volatile post-US election/pre-inauguration period. Conversely, the macroeconomic and monetary policy backdrop continues to look favourable, as does the prospect of more deregulation and tax cuts in the US presenting a tailwind to corporate earnings.

Within this context, what is the solution to the asset allocation conundrum? Where can investors place capital such that it will participate in further upside while protecting returns on the downside?

Can convertibles help provide a solution?

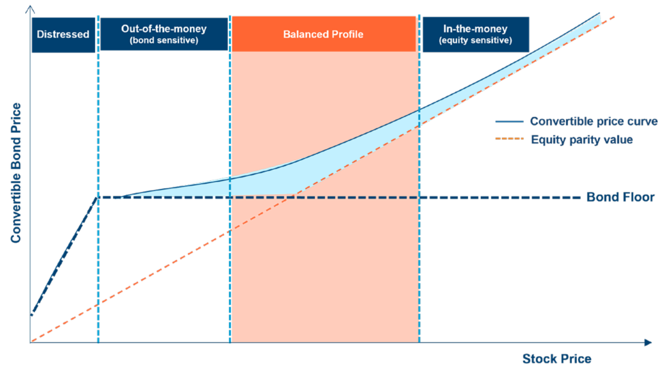
Convertible bonds are fixed income instruments that give investors the right, but not the obligation, to convert into a fixed number of shares at any time during their life.

Convertibles typically carry a five-year maturity and are senior unsecured rated, pari passu with the majority of a company's other publicly-traded debt. According to BoA Merrill Lynch, global convertibles are issued with an average of a 2.8% coupon and a 29.6% premium, which means it would be optimal for investors to convert if shares rise at least 29.6% during the life of the bond. With an average equity sensitivity (delta) of 52% for the Refinitiv Global Focus Convertible Index, convertibles therefore represent a rough mid-point between fixed income and equity.

By virtue of their hybrid nature, convertibles offer characteristics of both direct equity and fixed income markets. Specifically, they offer both the capital protection and income of debt instruments while offering upside exposure to rising equity prices.

Because the option to convert rests solely in the hands of the investor, convertibles offer a highly asymmetric payoff profile, as shown in the graph below. As equities rise, convertibles participate to an increasing degree, until the point where they trade in lockstep with equities with a 100% sensitivity to the underlying share price (a 100% delta).

Convertible asymmetric return profile



Source: Polar Capital, for illustrative purposes only.

Conversely, as equities fall, the equity sensitivity of a convertible progressively falls towards zero, at which point it is bounded by the value of the debt component alone (the bond floor). At this lower level, a convertible will act and trade as if it were a straight fixed income security. Consequently, absent distressed or bankruptcy scenarios, a convertible bond will have a level below which it never falls. Because the upside of a convertible is theoretically unlimited (as with equity), this then creates the highly attractive asymmetric risk/reward profile offered by the asset class.

This asymmetry provides three additional benefits: (1) the downside protection enables convertibles to dampen not only the downside exposure, but also the volatility one would typically associate with this degree of equity exposure.

It is for this reason that many view the asset class as providing 'defensive equity' exposures. Alternately, one can view the asset class as providing 'aggressive fixed income' exposure because of the other two benefits it provides: (2) namely that, uniquely among fixed income-paying securities, convertibles offer the potential for above-coupon returns over the life of the instrument, and (3) their income is generated with dramatically reduced duration (i.e. interest rate or credit spread) exposure compared to traditional debt markets. These benefits enable convertibles to provide equity-like exposure with bond-like risk characteristics.

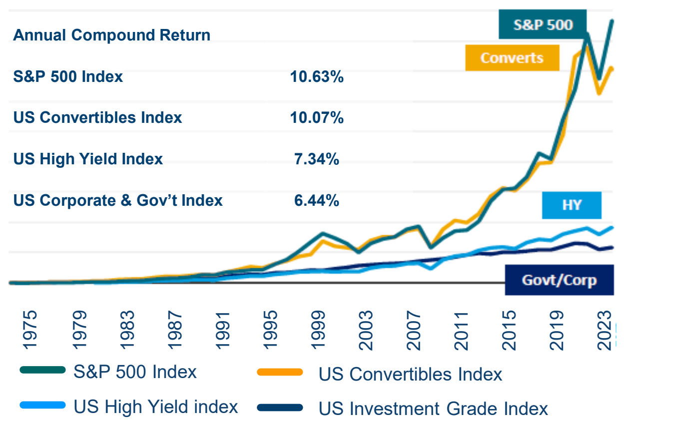
1. As of 11 November 2024

In terms of performance, US convertibles have matched equity performance over the past 40 years and done so with volatility that is analogous to high yield markets. As a result, numerous studies have concluded that including convertibles in portfolios expands their efficient frontier, enabling higher returns for any given level of risk.

These benefits, however, do require a few small concessions on the investors' part – most obviously, because of their embedded conversion option convertibles carry lower coupons than would be found on pari passu straight debt from the same issuer.

Additionally, in rising equity markets, convertibles will initially lag stocks due to their conversion premia and resultant equity exposures of less than 100%. However, as shown, for longer-term investors these concerns do not impinge upon performance.

US asset class performance (January 1973 - January 2024)

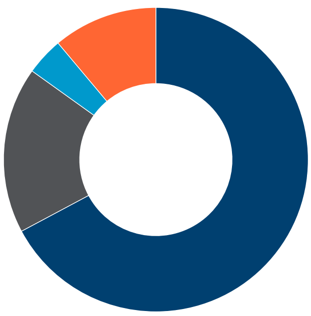


Source: BofA Global Research, ICE Data Services, LLC, Bloomberg, Lipper & Polar Capital, 31 January 2024. All BofA ML Indices except S&P 500 and MSCI World. Reprinted by permission. Copyright © 2024 Bank of America Corporation ("BAC").

Convertible market composition

Market capitalisation ($363.9bn)

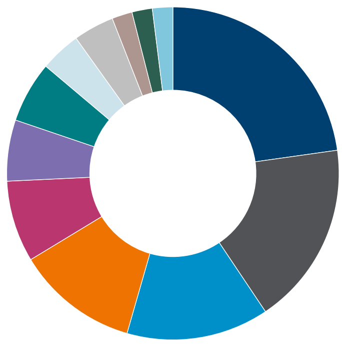
US	$244.6bn	(67.2%)
Europe	$64.5bn	(17.7%)
Japan	$14.5bn	(4.0%)
Asia-Ex	$40.3bn	(11.1%)



Source: BofA Merrill Lynch Global Research, 29 December 2023. Totals may not sum due to rounding. Reprinted by permission. Copyright © 2024 Bank of America Corporation ("BAC").

Global convertible: Sector composition

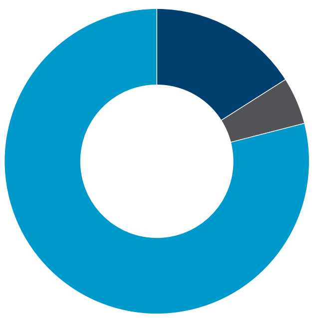
Technology	23%
Consumer Discretionary	18%
Financials	14%
Healthcare	12%
Industrials	8%
Media	6%
Utilities	6%
Tranportation	4%
Materials	4%
Energy	2%
Consumer Staples	2%
Telecommunications	2%



Source: BofA Merrill Lynch Global Research, 29 December 2023. Totals may not sum due to rounding. Reprinted by permission. Copyright © 2024 Bank of America Corporation ("BAC").

Global convertible: Credit rating composition

Investment grade	16%
Non-investment grade	5%
Not rated	79%



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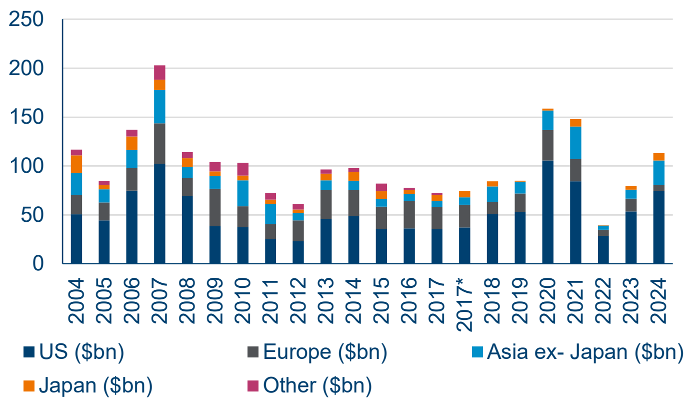
Annual convertible issuance (2004 - 2024)



Source: UBS Convertibles Marketing/Thomson Reuters, MACE Advisers & Polar Capital, *source from 2017 onwards: Bank of America Merrill Lynch. Date: 31 October 2024. Data for 2024 is annualised.

Conclusion

We believe the markets may be at or approaching another crossroads. In Japan and certainly in Europe there is very real political uncertainty and Germany, the engine of growth for Europe, seems to be mis-firing with the coalition government falling apart and elections called for early next year. Meanwhile, the political landscape in France remains unresolved. While we may now have political certainty in the US with the Republican clean sweep, it would be a brave person to predict the road ahead will be a certain one given the experience of the first Trump presidential term.

Economically, the US picture appears robust, although deglobalisation and the introduction of trade tariffs will ultimately slow growth and be inflationary, leading to a higher neutral rate than otherwise. It remains to be seen how China will react to the introduction of tariffs, but we can be certain they will react. In the meantime Chinese growth and the latest Chinese stimulus package has so far underwhelmed.

Yet despite these very clear headwinds the market has marched strongly forward, making new equity highs and breaching historic valuation metrics. At some point a pause, consolidation, correction or worse seems inevitable.

We believe convertibles offer investors caught in this investment dilemma an alternative asset class to consider. It is an asset class that is enjoying a renaissance of issuance from corporates and hence increased opportunities for investors and benefits from this increased uncertainty with a positive corelation to increased equity volatility.

The Polar Capital Convertible Team offers two strategies to take advantage of these opportunities – each with different risk characteristics and return profiles – but each run by the same award-winning, highly experienced global convertible team. We would be delighted to discuss with you the opportunities we see in this alternative asset class.

Polar Capital Global Convertibles Team
11 November 2024

Polar Capital Convertible Strategies

The team at Polar Capital manages two convertible strategies, each with different investment objectives and risk profiles.

Polar Capital Global Convertible Strategy

- This is a long-only convertible strategy seeking to generate capital appreciation through investing in the global convertible markets, together with income generation and capital protection
- The Strategy was established in 2013 and is still managed by the original founding portfolio managers
- The Strategy has delivered more upside and participated in less downside than its benchmark (the Refinitiv Global Focus Convertigle Bond Index)[2]
- Additionally, the Strategy has delivered superior income compared to its benchmark; the Historic Distribution Yield is 6.14%
- **12-month Strategy return 16.13%[3]**

Growth	Income	Protection
Target asymmetric, convex returns Identify clear upside catalysts Invest only when risk-adjusted returns are attractive	Target 6% Distribution Yield[4] Seek income without over-reaching Invest globally; geography and benchmark agnostic	Clear focus on limiting drawdowns Marco level: robust portfolio stress testing Micro level: detailed fundamental credit analysis

2. Upside/downside participation ratio analysis since inception two-day rolling basis

Polar Capital Global Absolute Return Strategy

- This is an absolute return-seeking strategy, targeting returns of c6-10% with volatility of returns of c6%
- The Strategy was established in 2018 and is still managed by the original founding portfolio managers
- The Strategy has never had a loss-making year and builds upon the track record of the ALVA Convertible Arbitrage strategy managed by the same team
- Taken together, the Absolute Return and ALVA strategies have an enviable 10-year track record of generating excellent risk-adjusted returns, **while never suffering any loss-making years**
- **12-month Strategy return 12.41%[3]**

Growth	Income	Protection
Return target 6-10% Volatility target 6% Identify clear return catalysts and target asymmetric returns	Target 5% Distribution Yield[4] Buffer created to smooth distributions	Clear fous on limiting drawdowns Low levels of correlation with other asset classes

3. Polar Capital, as at 31 October 2024. Performance figures represent the USD I Acc Share Class. For illustrative purposes only

4. Please note that this is the target yield as of 31 October 2024, it is not a guaranteed target yield and it is subject to change in the future

Historic yield is based on a NAV per share of US$9.11 and income of US$0.5592 per unit paid in the last 12 months, based on USD Institutional distribution units. **WARNING: Investors should note that historic yield does not measure the overall performance of a fund. It is possible for a fund to lose money overall but to have a positive historic yield. Historic yield cannot be considered as being similar to the interest rate an investor would earn on a savings account**

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Risk

- **Capital is at risk and there is no guarantee the Strategy will achieve its objective. Investors should make sure their attitude towards risk is aligned with the risk profile of the Strategy before investing.**
- **Past performance is not a reliable guide to future performance. The value of investments may go down as well as up and you might get back less than you originally invested.**
- The value of a Strategy's assets may be affected by uncertainties such as international political developments, market sentiment, economic conditions, changes in government policies, restrictions on foreign investment and currency repatriation, currency fluctuations and other developments in the laws and regulations of countries in which investment may be made. Please see the Strategy's Prospectus for details of all risks.
- The Strategy invests in fixed income, convertible, and equity securities, and share prices can rise or fall due to several factors affecting global stock markets.
- The Strategy uses derivatives which carry the risk of reduced liquidity, substantial loss and increased volatility in adverse market conditions, such as failure amongst market participants.
- will result in the Strategy being leveraged (where market exposure and the potential for loss exceeds the amount the Strategy has invested) and in these market conditions the effect of leverage will magnify losses. The Strategy makes extensive use of derivatives.
- The Strategy invests in assets denominated in currencies other than the Strategy's base currency. Changes in exchange rates may have a negative impact on the Strategy's investments. If the share class currency is different from the currency of the country in which you reside, exchange rate fluctuations may affect your returns when converted into your local currency. Hedged share classes may have associated costs which may impact the performance of your investment.
- There may be times where the issuer or guarantor of a fixed income [or convertible] security cannot meet its payment obligations or has their credit rating downgraded, resulting in potential losses for the Strategy.

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Further information about the Strategy's characteristics and any associated risks can be found in the prospectus, incorporation documents and financial statements. Please refer to these documents before making any final investment decisions. These documents are available free of charge via email by contacting Investor-relations@polarcapital.com or at www.polarcapital.co.uk.

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Benchmark (Global Convertible): The Strategy is actively managed and uses the Refinitiv Global Focus Convertible Bond Index as a performance target and to calculate the performance fee. The benchmark has been chosen as it is generally considered to be representative of the investment universe in which the Strategy invests. The performance of the Strategy is likely to differ from the performance of the benchmark as the holdings, weightings and asset allocation will be different. Investors should carefully consider these differences when making comparisons. Further information about the benchmark can be found https://www.refinitiv.com/en/financialdata/indices/convertible-indices.

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