Global Convertibles: A market and fund outlook

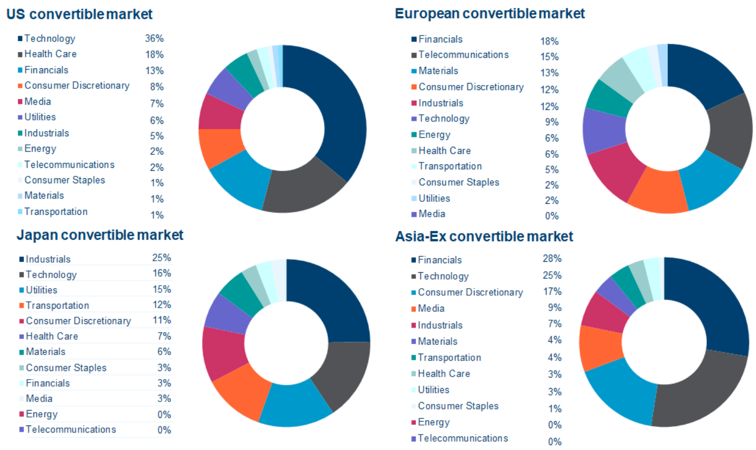
Coronavirus has hit all of us hard since the end of last year and the early part of 2020. For nearly six months, companies have looked at different ways to raise capital to shore up their balance sheets, and convertible issuance has surged as a result. With this as the background, David Keetley and Steve McCormick, fund managers in the Polar Capital Global Convertible team, recently hosted a webcast to discuss how convertibles have performed during this time as well as giving their outlook from here.

David Keetley
Fund Manager
David joined Polar Capital in October 2010 to establish the global convertible team and is co-manager of the Global Convertible Fund and the Global Absolute Return Fund.

Steve McCormick
Fund Manager
Stephen joined Polar Capital in October 2010 and is co-manager of the Global Convertible Fund and the Global Absolute Return Fund.

David Keetley: There has certainly been a surge of issuance which, as far as we can determine, looks set to continue, but new issuance is only part of the story. Convertibles as an asset class is currently trading at one of the most attractive levels seen in years. Valuations fell in March and while they recovered partially in April and May, they still remain at attractive levels but issuance and cheap valuations are still only part of the story. What is interesting is that as equity prices fell, convertibles, that were until recently deep in the money, also fell, taking them closer to their bond floors. Consequently, today they present a much more balanced profile. In other words, they represent true hybrids rather than just being bonds with very high equity sensitivities and what's more, the asset class is growing, presenting a broad and attractive opportunity set which we believe will be the case for some time yet as we will discuss.

Before we discuss current opportunities, let's first talk about the global convertible market composition. Today the market has a market cap of about $350bn but it's worthwhile noting it used to be about $450-500bn. Given the refinancing needs we now see, we anticipate the market can get back to that size over the next 18-24 months, as it's quite feasible to anticipate this asset class growing 30-40% over that time. We think it is also worth noting that the US, being some 60% of the global convertible market, represents an overweight position and therefore, if you are going to invest in the convertible market, I'd suggest you want to be looking at a fund that has feet on the ground in the US as we have. In terms of sectors, the market is also well diversified in all four regions as can be seen from the slide.



Source: BofA Merrill Lynch Global Research, 31 December 2019. Totals may not sum due to rounding.

Looking at the US, you can see that technology and healthcare represent a large proportion of that market and have been a source of great opportunity in issuance for us over the past few years. However, what is interesting over the recent surge is the amount of issuance away from

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Awards & ratings

Source: Polar Capital & Bloomberg, 29 May 2020. The following indices all show year-to-date price return performance in the indices base currencies. Prior to 21 February 2020 the Fund's benchmark name was Thomson Reuters Global Focus Convertible Bond Index. This is a name change only due to a rebranding of company. Past performance is not a guide to or indicative of future results. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this document. A list of all recommendations made within the immediately preceding 12 months is available upon request.

"If you lose less in market selloffs, it means you can compound returns from a higher base than equity markets and so recover more quickly as the market recovers"

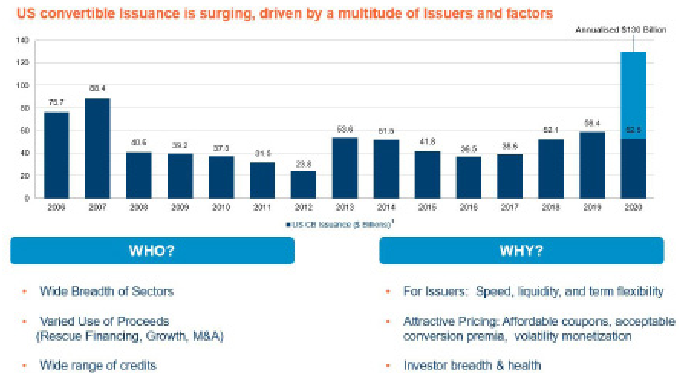
those sectors and we think that's particularly important as we anticipate that will continue and therefore the opportunity set will broaden going forward.

Now, I'm going to talk about the performance of the asset class year to date. This slide is probably my favourite slide in the entire deck but first let me make the obvious point that the slide illustrates – convertibles have been a clear outperformer.

Why have convertibles outperformed? And why did convertibles also outperform during the last substantial market fall in 2008-09? We also discuss this in an article published on the Polar Capital website in early March entitled, *Are Convertibles Doing Their Job?*. As we noted there, global convertibles have substantially outperformed global equities year to date, protecting 76% of capital as they participated in only 24% of the market slowdown. But how is that possible? What characteristics of a convertible enable that to happen? Well, it's the bond floor and it's the strength of the bond floor that protects capital on the way down. If you lose less in market selloffs, it means you can compound returns from a higher base than equity markets and so recover more quickly as the market recovers – we think this slide illustrates that point very well.

There's also another point as to why the convertible market outperformed this time just as it did also in 2008-09, and it's this: the fact that the convertible primary market remained opened during the COVID-19 crisis, where other primary markets closed. In other words, for companies that were keen or indeed desperate to refinance themselves in the public markets, there was really only one opportunity to do so and that was through the convertible primary markets. It was the convertible market that was in the driving seat and the convertible investments that had the pricing power that forced companies to issue paper cheaply, enabling convertibles to outperform in the recovery. I'll now hand over to Steve to drill down on the convertible primary markets in a bit more depth.

Steve McCormick: Thank you, David. I'm going to walk you through what's going on in the convertible primary market, giving you some detail into who is issuing so many convertibles and why. The chart below basically tells the whole story, with total issuance probably passing $150bn.



Source: 1. Deutsche Bank, 28 May 2020. Includes both public issues and liquid non-public issues via exchanges (e.g. CX BT9) over $50mn notional. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital, and may not be achieved. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this document. A list of all recommendations made within the immediately preceding 12 months is available upon request.

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Much of the activity is in the US where May saw the largest issuance ever, well over $20bn. In the first six or seven trading days of June we are at $7bn, so we're on pace to keep up or surpass May. The activity seems relentless and I'm going to go through what's going on and why.

"This is not opportunistic financing; it's just the opposite. This is needs-based for growth, for rescue, strategic M&A and also some refinancing. "

Traditionally, where there's a spike in issuance, it tends to be liquidity driven, with companies selling convertibles opportunistically. This is not opportunistic financing; it's just the opposite. This is needs-based for growth, for rescue, strategic M&A and also some refinancing. By who? It's a wide breadth of sectors; consumer discretionary is the rescue sector with its airlines, cruise liners, retailers and restaurants, in addition to the energy sector with oil dropping from $70 down to $20. The energy sector has to get its balance sheets in order. Tech, healthcare and industrials all played a part in the issuance in the past two months and it is interesting to note technology was only the third largest behind consumer discretionary and healthcare in this issuance trend. Again, there is a wide range of sectors involved but there's also a wide range of credit quality that talks to the opportunity set we have. We have credits from A- all the way down to CCC to explore and try to find interesting opportunities.

Why is the market so strong and why are corporations using convertibles? There are plenty of advantages – two interesting ones are speed and efficiency as we can efficiently tailor a convertible to the needs of the corporation. Their coupons are much more affordable than high yield; there's a premium pricing to equities so they're able to sell their common stock at higher levels; and, there's a volatility the company gets monetised which is embedded in the convertible so the higher volatility, the higher the premium they get for their equity. Corporations also like to issue convertibles because it broadens the breadth of their investor base among high yield players, growth and income, growth and dedicated convertibles. There is a renaissance that's taking place in convertibles so I will drill down into the different sectors that we see as the most exciting.

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Let's start by drilling down into the rescue financing deals. As you see from these logos, from casinos to cruise liners, to airlines, to retailers, that were not needs-based – this was rescue financing. Taking Carnival as an example, it's a poster child as the first company to come out and tap the capital markets with convertibles being involved. They raised $7bn to essentially negate the uncertainty of when they were going to start up again. Of this, $1.7bn was a convertible yielding 5¾%, and the balance was a straight bond yielding 11½%, so it shows you the dynamic of yield per straight bond versus a convertible and then they did some common issuance as well. This financing cleared the market at a very advantageous level for the investing community, and it put Carnival on the right track to survive for 12-14 months without any revenue. So, with that knowledge, the investing community took that as a green light and then the stock performed extremely well, with the convertible trading as high as 174. That's the case for many of these rescue financings, but I think the more interesting slide is the next one, which are the COVID-19 beneficiaries.

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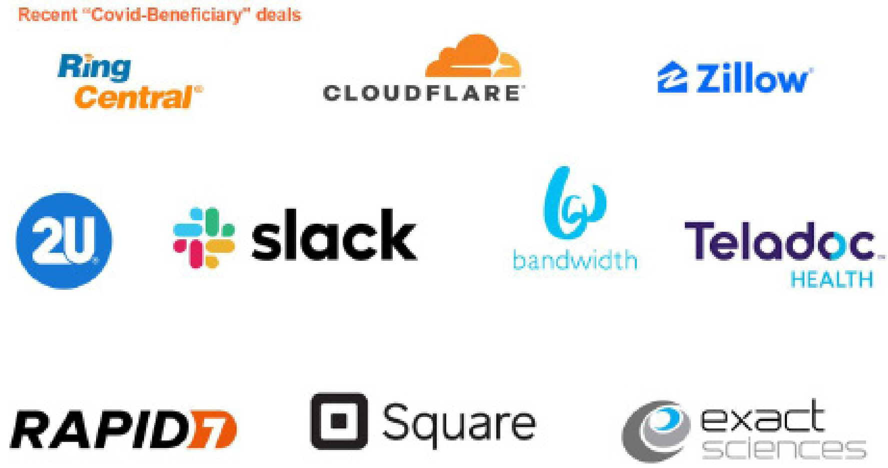

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Here, we're not talking about healthcare companies discovering vaccines or care for COVID-19 patients. We are talking mainly about technology companies involved in trends that have been accelerated due to the COVID-19 situation. Teladoc, for example, offers a healthcare consultation by telephone; Slack provides workplace collaboration; Rapid7 is a data security business and working from home has increased the need for the security by leaps and bounds. 2U provides online learning that universities are looking at setting up for the fall, hopefully. The interesting point is it's a business model I did not think worked in February and now they're getting incoming calls for companies, for universities trying to set themselves up to be able to open in the fall. It's interesting to note they did a $750m offering and they're going to need that money for growth with a 2¼% coupon and a 27% premium.

The next chart talks about why we think this opportunity set is durable, why we think it's going to continue.

"We think pricing is attractive and is going to continue to be so. It's at its cheapest level in years."

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We think pricing is attractive and is going to continue to be so. It's at its cheapest level in years – the average yield right now is 2½% with the average premium 30%, and with the volatility in the marketplace, the volatility in credit spreads, we think attractive pricing is here to stay. We see the tailwinds of increased volatility in the marketplace on needs-based financing. There's nothing really opportunistic going on and the wall of high yield debt supports ongoing convertible issuance, especially given their flexibility in this environment.

Lastly, the profile of a convertible has never looked better and I've been doing this for 34 years. We've had a lot of names that were deep in the money prior to March that have come back to a level where they look more like convertibles closer to their floor with a decent premium. The

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investor base has clearly embraced the new convertible profile, as have the corporates and the breadth of sector and breadth of quality is refreshing for us as investors because it enhances the number of opportunities we have to make money every day. We believe that the entire opportunity set has been reshaped for the asset class.

"Through this latest market sell-off, one of our objectives was to pick up attrative investment grade convertible bonds trading at distressed levels to further enhance [the Fund's] yield."

DK: Many thanks Steve. So, how do investors take advantage of the opportunities we've talked about and continue to see in the asset class? I'm going to talk about our two funds; firstly, the Polar Capital Global Convertible Fund. To recap the Fund's objectives, it provides capital growth and capital protection along with what we believe to be a very attractive 4% income yield. In many ways, it's a straightforward convertible fund, albeit we have feet on the ground in the US which many of our international peers don't have. But it's also differentiated by the depth of fundamental credit analysis we undertake on each of our positions, which is also why we believe we can protect capital well at the time of a market selloff. It's also differentiated by its 4% income target – a target we are very confident in meeting – and being able to pay out about 1% a quarter. Indeed, through this latest market selloff, one of our objectives was to pick up attractive investment grade convertible bonds trading at distressed levels to further enhance this yield.

By way of update to our existing investors, I'd like to briefly comment on some of our most notable portfolio changes as you see on the chart below.

Source: Polar Capital. 1. As at 29 May 2020. Please note June monthly return performance and year to date performance highlighted in red, as at 5 June 2020. Performance figures are quoted net of fees and in US Dollars (Class I US$ Acc). Daily return data since Fund launch, 30 August 2013. 2. Upside/downside participation ratio analysis since Fund Inception, two day rolling basis. The benchmark name changed on 21 February 2020 to Refinitiv Global Focus Convertible Bond Index. Prior to 21 February 2020 the Fund's benchmark name was Thomson Reuters Global Focus Convertible Bond Index. This is a name change only due to a rebranding of company. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this document. A list of all recommendations made within the immediately preceding 12 months is available up on request. Eurohedge Absolute UCITS Awards 2018. FE Crown Fund Ratings do not constitute investment advice offered by FE and should not be used as the sole basis for making any investment decision. All rights reserved.

We sold our positions in property, specifically in Derwent in the UK, Country Garden in Hong Kong and China, given the lack of utility of offices, shopping areas and malls going forward. We've also sold our position in Alibaba, as commentary developed about a possible delisting of Hong Kong or Chinese companies in the US. We have taken profits in our very profitable Cellnex position and still own a reduced position size. In Europe, we have taken profits in Viva Biotech, a Hong Kong-listed biotech company, and reduced some very attractive profits we've made in some of our US internet names, Chegg and Slack.

I have to apologise as well, as we too, along with the US, have been able to take advantage of some needs-based financing. Specifically, we have bought a convertible from issued by Amadeus, who make the software for most airlines, a bond that's been extremely profitable for us, and indeed we may top slice it shortly. We've also participated in a mandatory convertible for Arcelor with an attractive coupon, purchased a position in Bharti Airtel in India and, as Steve has already talked about, 2U Inc, the college facility provider, and Slack.

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By way of summary, the Fund has participated in less downside and more upside than its benchmark, while still consistently delivering and distributing a peer-beating 1% per quarter income, and we don't see any reason why either this outperformance or yield distribution can't continue going forward.

The Polar Capital Global Absolute Return Fund is a fund we launched at the beginning of last year and have been running quietly since, but we now feel the time is right to bang the drum a little harder. It is an absolute return fund, seeking to deliver good returns by typically being long the convertible and short the underlying equity. Being long/short means we can see positive returns regardless of market direction, a characteristic we hope will prove timely to investors in these challenged times. This also means we can extract the current cheapness in the secondary and primary markets efficiently, while maintaining limited equity exposures.

"The use of the equity short to hedge the long credit exposure embedded within the convertible…can make for a very effective and relatively cheap credit hedge."

Source: Polar Capital. 1. As at 29 May 2020. Please note June monthly return performance and year to date performance highlighted in red, as at 5 June 2020. Performance figures are quoted net of fees and in US Dollars (Class I US$ Acc). Daily return data since Fund launch, 31 December 2018. 2. Polar Capital Risk Team, 29 May 2020. 3. Actual returns are not indicative or a guarantee of future returns.

Typically, our equity exposure is less than 20% and for the majority of time since the Fund's inception, it's been around 10%, as it is now. A further advantage of being long convertible/short equity, is the use of the equity short to hedge the long credit exposure embedded within the convertible. This can make for a very effective and relatively cheap credit hedge. We believe this Fund is unique in its universe and while it does draw upon some elements of convertible arbitrage, it also draws upon the credit fundamental analysis approach used to great effect by our global convertible fund.

Finally, while this Fund is clearly seeing good prices generating some good returns, we believe those opportunities will be available for some time yet. Indeed, we believe this Fund is extremely well placed to take advantage of the renaissance in the convertible market in both the attractiveness and cheapness of the primary and secondary markets.

SM: Which brings us to our conclusion. We hope we articulated the change in landscape in the convertible market and the opportunity set that its diversification and growth have provided. We also want to make sure you take away the durability of this change that we think is ongoing. Our product range includes a Global Convertible Fund yielding 4% that has delivered more upside and participated in less downside than its benchmark since inception while our latest fund is well positioned to take advantage of this new fertile environment.

- Global convertible market is diversified and growing rapidly
- The asset class performance is now +ve year to date and has substantially outperformed
- Primary Issuance is surging; especially in the US
- There are 3 powerful reasons why the current opportunity set will be on-going
- The Convertible Team offers 2 funds to take advantage of these opportunities
  - Polar Capital Global Convertible Fund
  - Polar Capital Global Absolute Return Fund
- Both offer good, but distinct return prospects

Source: Polar Capital.

David Keetley and Steve McCormick

Fund Managers, Polar Capital Global Convertible Team

10 June 2020

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