The Case for Convertibles

Bond-Equity Hybrids Let Investors Keep Their Options Open

Convertible securities are the chameleons of the investment world, offering investors both the growth potential of common stocks and the income offered by bonds. Issued by companies looking to raise capital, these hybrid investments are generally structured as some form of debt (bonds, debentures) or preferred shares with an embedded option that allows conversion into common shares under predetermined conditions.

The debt features of convertibles stem from the interest payments and claim to principal. In this respect, convertibles are similar to bonds and characteristically are typically expected to provide better protection against erosion of value in declining markets than the underlying common stock. But they are also similar to stocks because their embedded conversion component allows investors to participate in the stock’s price appreciation.

If a company's common stock rises, the convertible security should increase in value because of the conversion option. If the common stock does not perform well, the fixed income component provides potentially better protection against losses than would the common stock alone. Because of these unique characteristics, convertibles may be classified as fixed income securities, equity securities, or as a separate asset class.

As securities that generate income, convertibles are generally attractive in low interest-rate environments when sources of income may be scarce. Historically, they 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 favor convertibles due to the price relationship with the underlying common stock. This ability to adapt to myriad market conditions makes convertibles an attractive vehicle for increasing a portfolio’s level of diversification.

Exhibit 1: Convertibles Performance in Varying Market Conditions
20 Years Ended April 30, 2016

Source: Morningstar. Past performance is no guarantee of future results. The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.
Why Companies Issue Convertibles

Convertibles allow companies to finance activities through a lower-cost form of debt that offers less potential dilution to the common shares than selling common stock.

Advantages to the issuer include:
• Lower interest payments relative to straight debt
• Less potential share dilution compared to equity issuance
• Equity issued at a premium to the current stock price
• Ability to reach a broader range of investors

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

Anatomy of a Convertible

Convertibles possess a distinct structure that includes characteristics that may be unfamiliar to some investors such as the conversion ratio, parity, conversion premium and delta (Exhibit 2).

Conversion ratio sets out the number of common shares due upon conversion to the underlying stock. The conversion price, which is calculated by dividing the price of the convertible at issue by the conversion ratio, determines the price of the underlying common stock that is required for the conversion value of the convertible to be greater than its par value. Generally, the conversion price is set upon issuance at a premium of anywhere from 15% to 50% relative to the price of the underlying common stock, with 20% to 30% the most typical range.

Parity refers to the value of the convertible if it were converted today. It is calculated by multiplying the conversion ratio by the current stock price.

Conversion premium is the value by which the price of the convertible exceeds its parity and is calculated as a percentage of parity.

Delta measures the sensitivity of the convertible price to changes in the price of the underlying common stock.

Busted, Balanced or Equity-Like?

Based on the conversion premium, convertibles can be broken down into three distinct categories: busted, equity-like and balanced.

Bond-like or “busted” convertibles are “out of the money”; they have a high conversion premium. Because the conversion price is substantially greater than the equity price, the conversion option is unlikely to be exercised. Busted convertibles have less sensitivity to the movement of the underlying common stock. Similar to bonds, they provide income and protection during market declines but offer less potential for upside participation.

At the other end of the spectrum are equity-like “in the money” convertibles. Their conversion price is equal to or less than the equity price but close to it, which results in higher sensitivity to the stock price. Because equity-like convertibles closely track the underlying stock, they can offer greater upside potential; however, this also means they are nearly as volatile as the underlying stock.

Exhibit 2: Types of Convertible Securities

The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.
The Case for Convertibles

Exhibit 3: Price Behavior of a Convertible

Balanced convertibles tread the middle ground with 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 participation in the potential upside return of the underlying stock and lower participation in the stock’s potential downside return.

Exhibit 4: Stock Movement Effect on Convertible

The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.
Four Good Reasons to Consider Investing in Convertibles

Current Income. Investors seeking yield from equity securities may find convertibles an appealing option, as they generally provide a more attractive income component than stocks alone (although generally lower than straight bonds), while still allowing participation in the stock’s price movement.

Attractive Potential for Long-Term Risk-Adjusted Returns. Critics point out that convertibles do not increase as rapidly in value as stocks during rising markets; nor does their downside protection equal that of bonds during market declines.

Nevertheless, historically they have delivered attractive long-term risk-adjusted returns compared to both stocks and bonds (Exhibit 5).

Potential for Additional Diversification. Historically, convertibles typically have exhibited a low correlation to fixed income and demonstrated imperfect correlation with stocks. This creates potential to enhance diversification, dampen volatility and improve an investor’s portfolio’s overall risk profile (Exhibit 6).

Convertibles’ attractive risk/reward profile can be illustrated using efficient frontier analysis (Exhibit 7).

Exhibit 5: Convertibles’ Risk/Reward Profile Compared to Stocks and Bonds
As of April 30, 2016

Exhibit 6: 15-Year Correlation of Convertibles with Stocks and Bonds
As of April 30, 2016

Exhibit 7: US Stocks, Bonds and Convertibles Efficient Frontier
15 Years Ended April 30, 2016

Source: Morningstar. Ten 10-year rolling periods, 3-month step. Past performance is no guarantee of future results. This chart is for illustrative purposes only and does not represent the performance of any Franklin Templeton fund. Risk as measured by standard deviation.

Source: Morningstar. Stocks are represented by the S&P 500 Index; bonds are represented by the Barclays US Aggregate Bond Index; convertibles are represented by BofA Merrill Lynch All US Convertibles All Qualities Index. Past performance is no guarantee of future results.

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Exhibit 7 shows the efficient frontier for two sets of hypothetical portfolios: one set (the green curve) is constructed using only stocks and bonds. The lowest point on the curve shows the risk and return of a portfolio invested 100% in bonds and 0% in stocks. This portfolio has achieved an annualized total return of 5.0% with 3.5% standard deviation. Moving along the curve to the right, the portfolio invested 90% in bonds and 10% in stocks produced a higher return of 5.3% with risk of 3.3%. The right-most portfolio on the blue curve is invested in 0% bonds and 100% stocks. It delivered the highest return of 5.5%. To achieve this return, an investor would have had to assume the greatest risk of 14.7%.

The blue efficient frontier shows a similar scenario for a set of portfolios invested in bonds and convertibles, instead of stocks. It is easy to see that the curve shifted up and to the left, which means that for a given level of return, an investor would experience less risk with the bonds and convertibles portfolio. For example, the 50% stock/50% bond portfolio produced a return of 5.8% and had a standard deviation of 7.1%. A portfolio of bonds and convertibles with the same allocation generated a slightly higher return of 6.2% with a lower standard deviation of 7.0%.

Exhibit 9 further illustrates balanced convertibles’ risk/return profile. Balanced convertibles (the green dot) have a beta lower than the equity market (as measured by the S&P 500 Index, the orange dot on the chart), yet have generated a higher total return.

**Robust and Diverse Opportunity Set.** The flexible nature of convertibles makes them appealing to a broad range of investors. As a group, convertibles have historically presented an attractive risk/reward profile, but within the group there is considerable variation in the level of risk, sensitivity to movements in the underlying stock, and upside participation potential. Convertible securities are diversified across credit ratings, sectors, market capitalization and investment characteristics.

### Exhibit 8: Convertibles Market Snapshot
**As of April 30, 2016**

<table>
<thead>
<tr>
<th></th>
<th>Market Value (Billions)</th>
<th>Number of Issues</th>
<th>Duration</th>
<th>Current Yield</th>
<th>Conversion Premium</th>
<th>Average Credit Quality</th>
<th>Delta</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Convertible</td>
<td>$193</td>
<td>475</td>
<td>3.14 Years</td>
<td>3.33%</td>
<td>36.02%</td>
<td>BA1/BA2</td>
<td>0.60</td>
</tr>
<tr>
<td>Balanced</td>
<td>$75</td>
<td>197</td>
<td>3.21 Years</td>
<td>3.46%</td>
<td>38.75%</td>
<td>BA2/BA3</td>
<td>0.57</td>
</tr>
<tr>
<td>Equity Sensitive</td>
<td>$79</td>
<td>148</td>
<td>1.91 Years</td>
<td>2.75%</td>
<td>8.37%</td>
<td>BAA3/BA1</td>
<td>0.83</td>
</tr>
<tr>
<td>Busted</td>
<td>$35</td>
<td>100</td>
<td>5.51 Years</td>
<td>3.59%</td>
<td>158.93%</td>
<td>BA2/BA3</td>
<td>0.19</td>
</tr>
</tbody>
</table>

Source: Barclays.

### Exhibit 9: Low Beta Equity Exposure
**As of April 30, 2016**

Overview of the Convertibles Market
With a value of over $193 billion as of April 30, 2016, the convertible securities market is a sizable player in US capital markets. Convertibles tend to have higher representation of small-cap companies relative to the broad equity market indexes, such as the S&P 500 Index. Convertibles issued by small companies represented over 30% of the investable universe by market value, mid-cap companies comprised about 15% and large-cap companies comprised 50%. In terms of credit ratings, the universe is tilted toward non-rated issues (almost half of total market value), with approximately 20% of securities carrying investment-grade ratings, and the rest rated below investment grade. The universe is also well diversified by sector, similar to the equity market (Exhibit 10).
Increasing New Issuance

Following a peak in 2007, convertibles issuance in the United States declined as companies took advantage of low yields, a high equity risk premium relative to credit spreads, and strong flows into the credit markets to issue straight debt rather than convertibles. The perception was that raising capital through straight debt was relatively cheap, even when convertible securities were issued at slightly lower rates due to the added concern of share dilution. Companies were also hesitant to issue convertible securities as equity valuations were inexpensive relative to historical levels. A sluggish primary market tends to improve as convertibles regain their attractiveness for issuers, and new issuance improved significantly in 2013, followed by an equally strong 2014, and comparable 2015. While as of April 2016 we have seen slightly softer issuance figures year-to-date, if we see better equity market performance, a rise in interest rates, or higher spreads this may help to strengthen the issuance trend.

Reducing Risk through Portfolio Construction

Some investors may have concerns about the credit profile of a convertible issuer. Active portfolio management, fundamental research, and a bottom-up approach to security selection can be used to address these concerns by targeting companies with rising credit profiles. While default risk is an important factor when evaluating securities, many other elements must be considered before making an investment, such as business fundamentals, asset and cash flow coverage of debt and fixed costs, and the likelihood of improvement in the underlying credit profile.

Convertibles: An All-Weather Investment

Although past historical performance cannot guarantee future results, based on historical characteristics, convertible securities offer the potential for low correlation to other asset classes and a broad universe of opportunities, which may help to reduce risk through portfolio diversification.

Convertible securities can provide opportunities for investors to “hedge their bets” by providing characteristics of both the fixed income and equity markets. For those seeking income and risk-managed equity exposure, these investments offer numerous potential benefits, including:

- **Low-beta equity exposure:** historically, convertible securities have tended to provide equity-like returns with lower levels of beta than common stocks.
- **Current income** that is usually higher than a common stock’s dividend, albeit typically lower than yields on non-convertible debt.
- **Additional diversification potential** and a means that seeks to improve the risk/reward profile in a portfolio due to imperfect or low correlations.
• A claim on the issuer’s assets senior to holders of common shares

• Robust asset class: the convertibles market can be considered a separate asset class due to its size, distinct composition of the issuer base and a unique risk/return profile.

Worldwide, convertible securities are garnering increasing attention from both issuers and investors. The asset class has ample room for expansion as companies look for financing and endeavor to attract investors to their common shares at the lowest possible cost. Convertibles offer attractive opportunities for participating in corporate growth, even in uncertain markets—possibly the strongest argument for including a component of convertible securities in a diversified portfolio of investments.

WHAT ARE THE RISKS?
All investments involve risks, including possible loss of principal. Generally, those offering potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of a portfolio may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Convertible securities are subject to the risks of stocks when the underlying stock price is high relative to the conversion price (because more of the security’s value resides in the conversion feature) and debt securities when the underlying stock price is low relative to the conversion price (because the conversion feature is less valuable). A convertible security is not as sensitive to interest rate changes as a similar non-convertible debt security, and generally has less potential for gain or loss than the underlying stock.
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