A Leading Global Investment Management Firm

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Rising Convertible Issuance May Aid Insurers Concerned with Inflation, Interest Rate Increases

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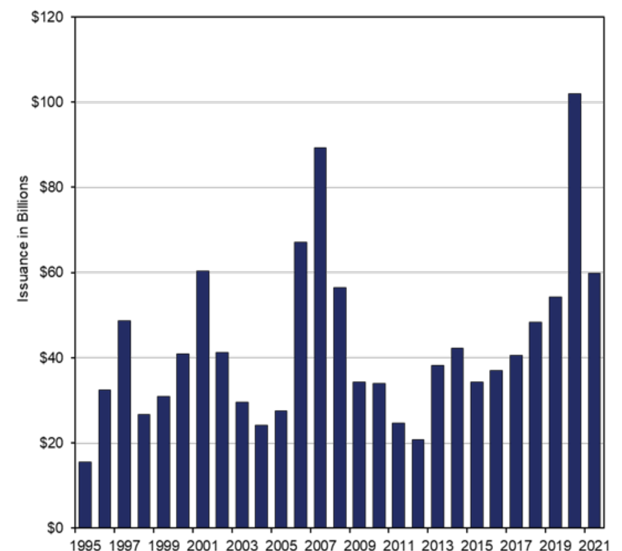
Convertible bonds' record issuance (see Figure 1) is a timely resurgence in an asset class that may help insurers concerned with inflation and potential interest rate hikes.

An asset once more prominent in insurance portfolios over a decade ago, convertible bonds are designed to offer insurers the upside potential of equities - the securities can be converted into the common stock of the issuer - with the downside protection of a bond. Their bond-like risk-based capital (RBC) charges make convertibles an efficient tool to aid capital growth, a valuable feature should current inflation prove to be more than transitory. Convertibles may also help insurers hedge against a potential rise in interest rates rise that could affect fixed income portfolios.

Convertible issuance fell considerably following the 2008 financial crisis, especially among investment-grade companies, in part because declining interest rates made bonds a less expensive vehicle for most corporate financing needs. However, convertible issuance has spiked recently due to financing needs from newer companies, for which convertibles are a typical first issuance after an initial public offering (IPO), as well as from established companies raising equity to preserve ratings and financial flexibility.

Insurers considering this asset class may want to ensure they have the necessary expertise. Evaluating convertibles in terms of their relative bond and equity values and in determining their fit for an insurer's portfolio is essential to considerations of this asset class.

Figure 1 Total U.S. Convertible Issuance 1995-2021*



*As of June 30, 2021

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Opportunities for Insurers

While U.S. corporate bond issuance steadily increased during the past decade to nearly $2.3 trillion outstanding in 2020,[1] corporate equity and convertible issuance has been relatively flat. As Figure 1 illustrates, annual convertible issuance only surpassed $60 billion twice since 2000 before it reached $100 billion in 2020; Conning thinks issuance could reach $100 billion again in 2021.

Convertible issuance tends to correlate with equity issuance. While the number of U.S. public firms fell precipitously to some 4,300 in 2019 from the peak of almost 8,100 in 1996,[2] more new companies are going public: 2020's 209 IPOs was a significant increase over the average since 2015.[3] Newer companies often issue convertibles after their IPO because they are challenged to get a high enough rating to issue a normal public bond. In addition, many new companies are growing rapidly and investors want a chance to participate in the upside. Established companies issue convertibles seeking to raise equity for other purposes like preserving ratings, building liquidity, or financing an acquisition. Convertible issues are generally at least $500 million, similar to corporate bond levels. Liquidity in convertibles tends to track that of the equity markets and convertibles are often more liquid than corporate bonds in difficult markets.

Conning leverages our deep expertise in credit analysis to evaluate convertibles, a valuation-driven approach that includes an issuer's fair credit spread and expected volatility. Our credit analysts and traders provide current and historic insights on credit quality and our analysts also identify names that we are not comfortable with regardless of price.

Conning's view regarding convertible strategies for insurers is that the risk profile should be about halfway between stocks and bonds (see Figure 2). As convertible returns are more correlated to equities than interest rates, convertibles are typically the initial equity choice in a strategic asset allocation analysis – showing up as the first exposure to equities in the lower risk part of the efficient frontier with common stock introduced in the higher volatility part of the curve. We tend to focus on higher quality issues so that the fixed income floor can provide the protection our clients are seeking.

We find that diversification is less important from a loss aversion perspective but may increase the possibility for upside surprises. Therefore, we focus on investment-grade and BB-rated U.S. issues as well as foreign issues, mainly investment grade, that pay in dollars. We have also been able to identify select securities among the vast amount of unrated issuance with metrics that could be considered investment grade or high below-investment-grade. We will purchase these securities if we think they will help clients better meet portfolio objectives, where they meet our credit underwriting and risk guidelines, where client guidelines allow them, and where we can get appropriate NAIC ratings.

Navigating the Conversion

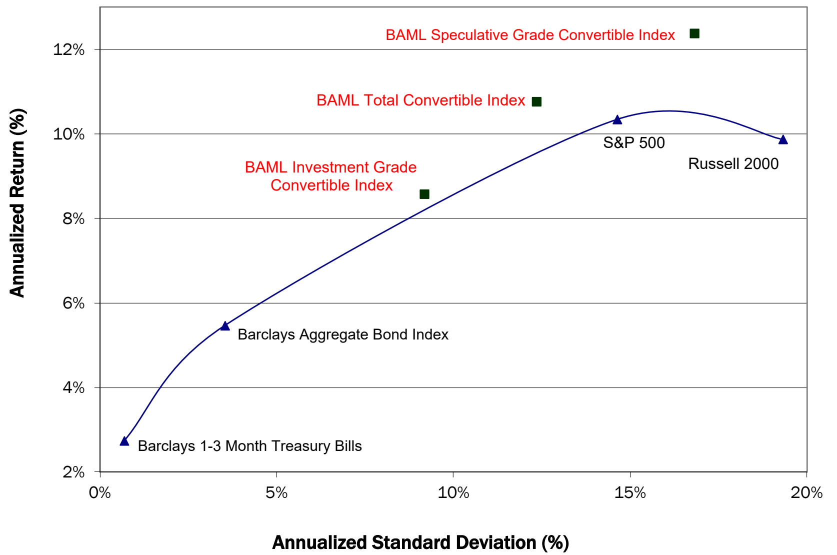
As highlighted in Figure 3, investing in convertible securities requires skill in both credit and equity analyses as well as in evaluating the bond-equity trade-off that supports an insurer's unique needs.

The straight diagonal running from lower left to upper right shows the parity value of the convertible – i.e., the value the security would have if the issue was converted into stock – which increases with the issuer's stock's price. The horizontal line across the middle shows the bond value of the convertible, which doesn't change with movement in the price of the underlying stock.

The curved line above the shaded area shows the fair value of the convertible. As the chart title indicates, convertible pricing becomes more sensitive to equity values the higher the equity price moves; as the bond price moves up significantly, it trades more like an equity, albeit with a better yield. The sweet spot appears to be in the center of the chart, where the issue is between behaving like a bond and a stock.

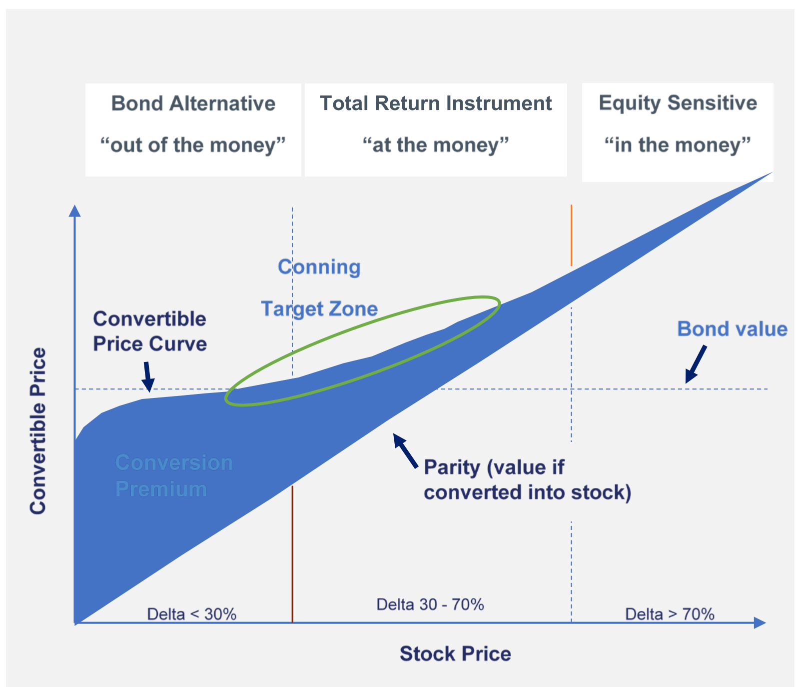
Figure 2 Asset Class Average Annual Returns

Since Inception, June 30, 2007 to June 30, 2021



Prepared by Conning, Inc. Sources: Bloomberg Index Services Limited. Used with permission and ICE Data Indices, LLC ("ICE DATA"), is used with permission. Since inception, Conning's convertible strategy has generated both risks and returns about halfway between the broad stock and bond market indices.

Figure 3 Conning Price Behavior vs Underlying Stock



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The questions for investors at this point center around the value of the optionality in the convertible, represented by the premium paid over both its pure stock and bond values and the lower yield it offers relative to that of a similar-maturity nonconvertible. Conning analyzes this based on our evaluation of the issuer's credit risk and the future price range (volatility) of its underlying stock price, as well as other factors including the bond's final maturity date and coupon rate, any call and/or put features, dividend outlook and treatment, and bond subordination and covenants.

Conclusion

Insurers are seeking to generate growth amid increasing inflation concerns and talk of interest rate hikes. The recent increase in convertible bond issuance is timely, as they are designed to offer the upside potential of equities with the downside protection and lower RBC charges of a bond, along with potential added diversification as there are many new issuers. However, they can be a complex asset to understand and implement and Conning suggests that insurers considering convertibles work with a manager highly experienced in analyzing the credit aspect of the security and one with a deep understanding of an insurer's goals.

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David A. Tyson, Ph.D., CFA, is a Managing Director and Portfolio Manager. He is responsible for managing Conning's convertible portfolios and is also a member of the team managing the firm's dividend equity strategies. Mr. Tyson previously served as Chief Investment Officer of Citigroup's proprietary insurance companies and head of Travelers' registered investment advisory. He also managed Travelers' convertible portfolios. Mr. Tyson earned a degree in finance/political science from the Wharton School of the University of Pennsylvania, and an MBA and Ph.D. in economics from the Stern School of Business at New York University.

About Conning

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Risks of Investing in Convertible Bonds

- Equity market declines which reduces the value of convertibles' equity conversion features.
- A high level of corporate defaults or a sharp widening in corporate bond spreads which reduces the value of convertibles' fixed income floors.
- Low supply of issues due to prolonged low interest rates and strong demand for investment grade corporate and high yield debt.

Footnotes:

[1] Source: © 2021 Securities Industry and Financial Markets Association (SIFMA), "US Fixed Income Securities: Issuance, Trading Volume, Outstanding," as of Aug. 9, 2021. Used with permission

[2] Source: The World Bank, World Federation of Exchanges database, "List of domestic companies, total – United States," as of July 31, 2021 https://data.worldbank.org/indicator/CM.MKT.LDOM.NO?locations=US

[3] Source: ©2001 SIFMA, "Capital Markets Fact Book 2021," July 2021, table "US Equity Issuance – Number of Issues." Used with permission.

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