
Market Commentary: First Quarter 2015¹

Overview

The U.S. convertible market, as measured by the BofA Merrill Lynch All Convertible Index, rose 3.02% during the first quarter of 2015, while underlying equities climbed 2.98%. During the period, investment-grade convertibles, as measured by the BofA Merrill Lynch Investment Grade Convertible Index, were up 0.56%, while speculative-grade convertibles fell -0.73%.

For the first quarter of 2015, the Standard & Poor's 500 Index rose a mere 0.95%, however, the broader Russell 2000 Index, which may better reflect the issuers in the convertible bond market, climbed 4.32%. During the quarter, the BofA Merrill Lynch All Convertible Index managed to capture nearly all of the equity market's upside. The first quarter return highlights the relationship between convertible bonds and interest rates – essentially that there is virtually none. Unlike most other fixed income categories, convertible performance is largely tied to the performance of equity markets and not interest rates.

We continue to believe that equity markets will be higher in the coming twelve to eighteen months as economic growth in the U.S. continues at a slow pace, while Europe's stagnant economies begin to expand in fits and starts. The sharp decline in energy prices should provide some material stimulus to those countries and regions that are net importers of oil and gas, particularly Europe and Japan. In addition, the Federal Reserve is likely to continue a monetary policy of low interest rates, which should foster a healthy climate for stocks and equity-linked securities such as convertibles.

We continue to believe that equities, and equity-linked securities, such as convertibles, are attractively valued, particularly when compared to the yields on pure fixed income securities, specifically U.S. Treasury and investment-grade bonds. We maintain that in a slow growth environment, at current valuations, convertible bonds and stocks are attractive and should continue to perform well.

In the first quarter, sector results were mixed. The Healthcare, Transportation, Telecomm and Consumer Discretionary sectors each rose in excess of 5% over the period. Conversely, Materials (down 8.9%), Utilities (-2.5%), Media (-1.8%) and Energy (-1.5%) were the worst performing sectors.

During the quarter, over 20 new issues totaling nearly \$16 billion came into the U.S. convertible market, while approximately \$3.4 billion has been redeemed through redemptions and maturities, according to BofA Merrill Lynch Research. Year-to-date, approximately \$7 billion has been issued in the U.S. market. Although the recent issuer base has been well diversified across market-cap and sector, the vast majority of issuance over the past year has been non-rated. As previously noted, we expect new issuance from investment-grade companies to remain depressed until the yield on the 10-year U.S. Treasury exceeds 3.5%.

Outlook

The past fifteen months have been very benign for the convertible market, which is somewhat surprising given that many were expecting a pullback following the tremendous advance in 2013. The past two and a half years have marked the resurrection of a vibrant market for new convertible issuance, which continued in 2014 following 2013's nearly \$50 billion of new issuance. The surge in new issuance was largely due to the simultaneous rise in stock prices and interest rates. With the rise in rates, issuing companies could once again realize a significant interest savings by issuing a convertible bond instead of a non-convertible high-yield security. For most investment-grade companies, however, rates remain so low in absolute terms that the benefits of a convertible offering remain relatively muted. As such, the preponderance of new issuance in 2013 and 2014 has been from non-investment grade companies. In addition, following the stock market decline of 2008, companies were reluctant to issue equity-linked securities as they believed that doing so would dilute existing equity holders at prices they believed under-

valued their companies. However, with stocks at near-record levels, companies are no longer reluctant to issue a security linked to their equity.

The asset class' strong two-year returns are a testimony to the notion that convertible bonds should outperform in a rising rate environment and, unlike nearly all other classes of fixed income instruments, have almost no correlation to the movement in interest rates. We believe this trend will continue as long as the economy remains in recovery mode.

We remain convinced that convertible bonds and equities are attractively valued in the current slow growth environment. Given the slowly improving macro economy, and the relatively low rates of interest and inflation, stocks appear inexpensive based on various measures such as price to earnings, price to cash flow or price to free cash flow. As such, we expect convertible bond and stock prices to be higher in the coming twelve to eighteen months.

Convertible bonds remain an excellent vehicle through which to participate in further equity advances. At current valuations, convertible bonds should participate in the majority of the stock market's advances, but less than half of any decline in the event that our outlook for equities is wrong.

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