Winning by not losing: Convertible Bonds and Closed-End Funds

CEFA was joined by F. Barry Nelson, Partner at Advent Capital Management LLC. The following Q&A recaps a discussion about how convertible securities found in closed-end funds offer a compelling opportunity to add value in portfolios given the volatility that has re-emerged in the market. As part of CEFA's podcast series, the podcast audio can be heard here.

F. Barry Nelson

CEFA: **Hello, and welcome to the latest podcast in the Closed-End Fund Association's continued series, Investment Insights. Joining us on today's podcast is Barry Nelson, CFA and partner at Advent Capital Management. Hi, Barry. Thank you for joining us today.**

FBN: Hi, Diane. Thank you very much. It's my pleasure to try to explain the attractions of convertible securities.

CEFA: **Barry, Advent is mostly known for managing convertible securities. How do the benefits and risks associated with convertibles fit with our current market environment?**

FBN: Actually, we think convertibles are really timely at the moment because we are in a period of market volatility and uncertainly, headline risk, every kind of concern is obvious. And here we have an asset class that historically, has provided equity-like returns over cycles but has achieved those equity-like returns with less volatility than equities and with less draw downs, with less downside risk than equities. Moreover, if one wants to be theoretical, the conversion right in a convertible amounts to an embedded option and the value of an option should rise when volatility rises.

CEFA: **Well, the fourth quarter of 2018 saw significant volatility across markets and many of the headline risks are still unsettled. What has the impact been on valuations and convertible securities? Are there opportunities at these valuations going forward?**

FBN: Well, there certainly were opportunities in the fourth quarter, although many of them have since corrected. Frankly, it really helps to have an actively managed strategy with professional convertible portfolio managers who are in the market every day and who can pounce when fleeting opportunities appear. And it seems highly likely that in this period of uncertainty, that volatility will continue and that there will be bargains looking ahead.

CEFA: **Barry, passive investment strategies and various asset classes have gained a lot of traction in recent years. Advent is an active investment manager. In the convertible sector, what advantages do you see for an active manager with respect to managing risk and adding to performance?**

FBN: It is not as difficult to add value in convertibles as it is in equities. The convertible market is a niche, it's less picked over than equities and it also lends itself to active strategies that don't just focus on the convertible market as a whole, but that focus on the more attractive parts of the convertible market; that is, strategies that focus on the higher yielding convertible issues which obviously are favored in closed-end fund formats since these are income products. And also, convertible strategies that simply avoid convertibles that have swerved far over par and that effectively no longer have good downside protection and no longer mute the volatility.

And on the research side, researching convertibles, credit research is key to be sure to be confident that we do have the downside protection afforded by the convertible fixed income instruments. And I can tell you that it's a lot easier for credit research to conclude that a company is not likely to default. It's a lot easier to avoid defaults than it is for a common stock analyst to avoid stocks that happen to go down. We specialize in credit research at Advent Capital.

CEFA: And how do you see an advisor or investor best positioning an allocation to convertible securities using closed-end funds within an investor's diversified portfolio?

FBN: Well, it's a very attractive way to access the convertible market through a closed-end fund because the convertible market is primarily an institutional market that individuals cannot invest in directly or at least it's very difficult. And secondarily, of course, we see closed-end funds, including our own AVK, trading at a double digit discount. And here we have income products that are especially appropriate for retirees and others who depend on their investments for their income and most of the convertible closed-end funds provide monthly distributions. If you've bought a fund at a 10 or 15% discount, you do not get discounted money when the distributions come. They are always at 100 cents on the dollar.

CEFA: How is it possible for convertibles to perform as well as equities over time, given that convertibles are issued at a premium over conversion value?

FBN: That's an easy one to answer. The key is that investing in convertibles is a way to achieve favorable performance by not losing; winning by not losing. And the answer is when you look at the numbers over time, that convertibles do not capture all of the upside whole market but they capture most of it. But on the downside, they suffer a lot less of the downside than the stock market. Convertibles suffer a smaller percentage of the downside than they gain on the upside. So we win by not losing. We're going to collect our two, three, four, five percent yield if we narrowly avoid defaults, regardless of whether the underlying stocks are in a bull market or a bear market.

CEFA: And what will happen to convertible securities if interest rates rise further?

FBN: Historically, convertibles have typically outperformed all other fixed income classes; that is, treasuries, corporates and usually high-yield bonds in periods of rising rates. And the key to this phenomenon is that rising rates are usually a consequence of a favorable economy that results in a favorable stock market. Convertibles are capturing most of the upside of a strong stock market in a time when straight bonds are being devalued in the market because the market is demanding higher yields.

CEFA: Barry, why haven't more people taken advantage of convertible securities?

FBN: Well, convertibles are a niche and it's a niche that seems complicated. It's something that you can't easily describe in a sound bite so it just doesn't fit with most of the media. Although it's a $400 billion market globally, it's just not mainstream and further, it doesn't fit with asset allocation models. Robo advisors are never going to recommend convertibles since, in a sense, convertibles make their own asset allocation automatically in that convertibles tend to become more equity-sensitive when stocks are going up and more bond like when stocks are going down. So very few financial advisors focus on convertibles and not many money managers manage convertibles.

CEFA: Well, Barry, thank you again for being with us today and sharing your insights.

FBN: My pleasure, Diane.

CEFA: And thank you for tuning in to another CEFA podcast. For more educational content, please visit our website at www.cefa.com.