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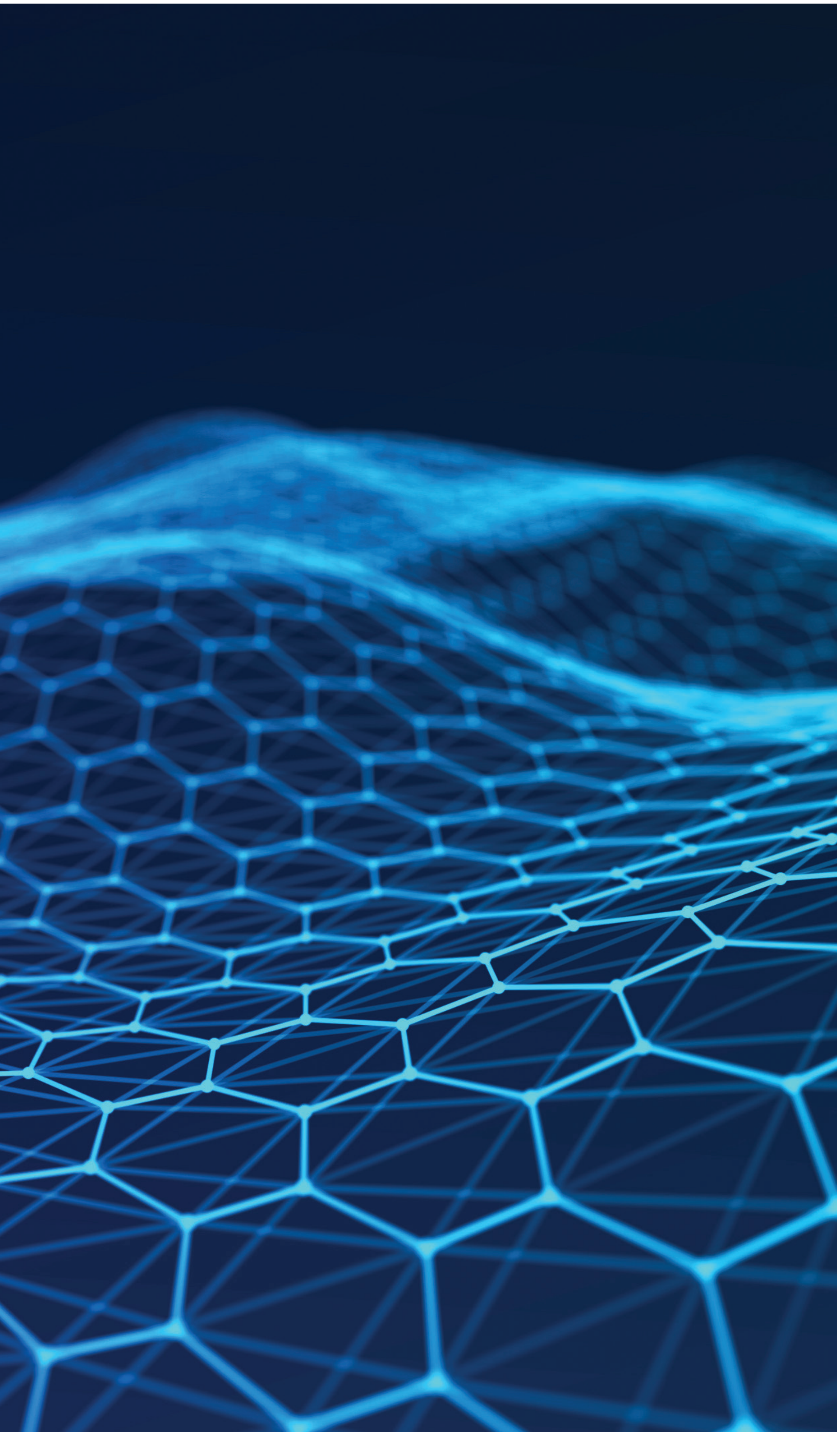

2021 Market Outlook

Rolling with the Punches: Why Investors Should Consider Convertibles in 2021

2020 will go down as an awful year in history, but as investors it is always important to look for opportunities created by major events. Consider convertible bonds: Amidst all of the devastation of 2020, convertible bonds thrived.

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Global Convertible Bonds

FIXED INCOME | GLOBAL FIXED INCOME TEAM

Through November 30, the return on the Refinitiv Global Focus Index (USD hedged) was 18.59%, among the best years on record. Further, global convertibles issuance in the first 11 months was $145bn USD, the highest since 2007. None of this was expected at the start of the year, and could not have been, as the traumatic occurrence of COVID-19 also created an impact on technology and the higher volatility conditions which granted a rebirth to the convertibles market.

In order to make sense of a bizarre 2020 and to look ahead to 2021, we examine the three key factors that played a significant role this year, and consider the part they could play in 2021.

1. **CONVERTIBLES HAVE PERFORMED WELL WHEN STOCKS PERFORMED WELL.** Certain sectors have higher representation in the convertibles market so equity sector performance is a key determinant of convertible return.
2. **CONVERTIBLES ARE EXPECTED TO OUTPERFORM STOCKS WHEN VOLATILITY IS HIGH.** The embedded equity option becomes more valuable in volatile stock markets.
3. **CONVERTIBLES VALUATIONS ARE AFFECTED BY TECHNICAL FACTORS SUCH AS SUPPLY AND DEMAND.** Market equilibrium is challenged when material changes occur in supply or demand. These changes create both challenges and opportunities.

Let us examine each of these factors in detail both as an analysis of 2020 return factors and as inputs for attempting to forecast what might transpire in 2021.

DISPLAY 1

Equity Returns Were Concentrated in a Handful of Sectors
MSCI Global Equity Sector Returns

GROWTH SECTORS		VALUE SECTORS	
MSCI WORLD/TECHNOLOGY	36.43	MSCI WORLD/INDUSTRIAL	9.55
MSCI WORLD/ CONSUMER DISCRETIONARY	29.83	MSCI WORLD/ CONSUMER STAPLES	5.70
MSCI WORLD/COMMUNICATIONS	19.05	MSCI WORLD/ENERGY	-32.98
MSCI WORLD/HEALTH CARE	10.65	MSCI WORLD/FINANCE	-7.00
		MSCI WORLD REAL ESTATE	-6.45
		MSCI WORLD/MATERIAL	13.92
		MSCI WORLD/UTILITY	3.82
AVERAGE RETURN	**23.99**	**AVERAGE RETURN**	**-1.92**

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

Source: MSIM, Bloomberg as December 11, 2020

1. CONVERTIBLES HAVE PERFORMED WELL WHEN STOCKS PERFORMED WELL

Most investors will appreciate the observation that the dominant risk in a convertible bond is the embedded equity option. Mathematically, a typical convertible at issue with $100 par might be $85 of straight bond and $15 of equity option, but that 15 percent piece typically determines around half the risk and return for the combination because it is the more volatile of the two assets. And the more volatile the stock, the more valuable the option, which in turn lowers the borrowing cost for the issuer. Hence, companies with volatile share prices are more likely to issue a convertible than companies with low volatility. For that reason, the convertible bond market is heavily weighted in volatile growth sectors such as technology, consumer discretionary, biotech and communications. As of November 30, 2020, the Refinitiv Global Focus Index (USD hedged) was 64.6% weighted in these four sectors. This was not just a good thing in 2020; it was a very good thing. *Display 1* shows that using MSCI Global equity sector indices, these four growth sectors delivered a return of 23.99% in 2020 (through November 30, 2020) compared to -1.92% for the other seven sectors.

The growth of technology is most prevalent in the U.S., where we observe that the six largest stocks (Facebook, Apple, Netflix, Microsoft, Amazon and Google, sometimes called FANMAG) now account for around 25% of the market capitalization of the S&P 500 index.

Display 2 shows the dramatic performance difference of these companies versus the rest of the U.S. market in 2020. Through 11 months, the S&P 500 has returned a healthy 12.1% but if we separate the FANMAG group from the rest, we observe that FANMAG returned 83.72% while the "S&P 494" returned -1.11%!

It is important to ask whether these stocks are now overvalued, but it is also important to recognize the power of their earnings and growth which has driven market sentiment. Consider these facts:[1]

- Since the start of 2015 through the first half of 2020, the forward revenues of FANMAG have risen 115% compared to the 2.6% increase for the rest of the S&P 500.
- Over the same period, the forward earnings of FANMAG are up 95% while the rest of the S&P 500 are down 1.9%.
- The profitability of FANMAG comes not just from their incredible revenue growth but in their margins—again over this period, FANMAG had forward profit margins of 15.5% compared to 10.3% for the S&P 494.

Equity investors know that stock markets greatly value growth, and the more profitable that growth is, the more highly it is valued. In a pandemic-driven world, many of the trends that were driving the use of technology have accelerated. Much of the technology sector is among the biggest beneficiaries of the economic upheaval created by COVID-19 and is well placed to benefit long after the crisis is over as more work, shopping, education and entertainment go online.

It is not just the stock market where we see the increasing impact of technology on our lives. The theme described above that "technology drives the stock market" is well known, but the idea that "technology drives the economy" is still not fully appreciated. Yet it is not unimaginable that the latter drives the former:[2]

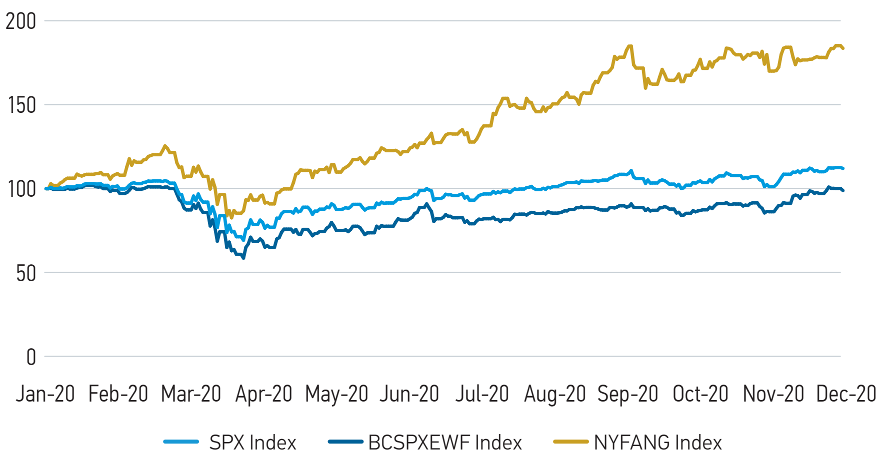
- Technology is now the biggest contributor of capital expenditure at over 50%. Capex is the mother's milk of productivity. And productivity drives GDP.[2]
- The so-called "digital economy" is still only 9% of US GDP, but it has contributed a whopping 32% of GDP growth over the past 14 years.[2]
- With technology at the steering wheel, GDP will likely grow faster than it otherwise would, helping to keep inflation lower for longer.

As with the theme we observed above in the equity market, these trends have only accelerated in the pandemic driven world. *Display 3* below shows that tech equipment spending took off in Q3 as firms adjusted to evolving business conditions.[3]

DISPLAY 2

Equity Markets Driven By FANMAG Stocks

12/31/3019 – 11/30/2020



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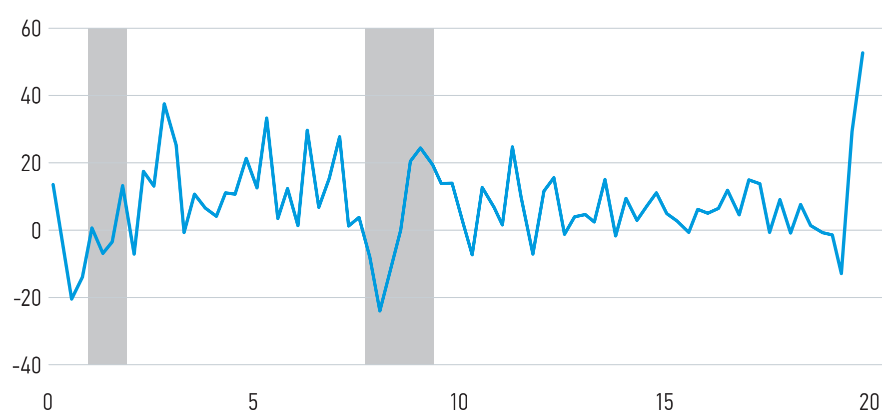
Sources: MSIM, Bloomberg as November 30, 2020

DISPLAY 3

Business Investment Spending on Tech



Source: U.S. Bureau of Economic Analysis, as of November 30, 2020

[1] http://blog.yardeni.com/2020/07/the-magnificent-six-stocks-that-are.html

[2] https://research.cornerstonemacro.com/ResearchPortal/Download?E=jgegkdfbha

[3] https://markets.jpmorgan.com/research/email/-p4sn4fu/cYVI-08qblz_8Xuygfeevw/GPS-3540216-0

Looking at all the evidence above, it is clear that the digital economy has driven the equity market in recent years and even more so in 2020 given the changes brought about by COVID-19. This has had an outsized impact on the convertibles market given the higher weight of volatile growth issuers in our market. We see a continuation to these trends in 2021 as economic growth is positioned to rebound once vaccines are widely available. Stocks should continue to perform and technology should continue to be the engine.

DISPLAY 4
Low Volatility Has Historically Created Subdued Returns for Convertibles

	MXWD	LGDRTRUU	60/40 MIX	FOCUS	DIFF	VIX
Jan.1.16 - Dec.31.18	7.20%	3.02%	5.53%	1.46%	-4.07%	14.5%
Jan.1.19 - Nov.30.20	20.12%	10.13%	16.12%	16.54%	0.42%	22.1%

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Sources: MSIM, Bloomberg as of November 30, 2020.

2. CONVERTIBLES TEND TO PERFORM WELL AS VOLATILITY RISES

A convertible bond is comprised of a regular corporate bond and an equity option. The more volatility there is in the equity market, the greater the value of the option as there is a higher chance it will mature in-the-money. That means when volatility is rising, convertible bonds become more valuable.

We can see this by comparing a calm period to a stormy period as in *Display 4*. In the three years from January 1, 2016 through December 31, 2018, global growth slowed, rates fell and volatility declined too, as can be witnessed by an average VIX level of just 14.5%. In that period, MSCI global stocks delivered an annualized return of 7.20% while the Bloomberg Barclays Global Aggregate Total Return Index provided a per annum return of 3.02%. The return for convertible bonds is normally expected to be between that of bonds and stocks as the risk is comprised of both. More precisely, expected convertible bond performance can sensibly be compared to a balanced portfolio of approximately 60% stocks and 40% bonds. A 60/40 mix of stocks and bonds from 2016 to 2018 returned 5.53%, yet the Refinitiv Global Focus index returned just 1.46% per annum, underperforming the 60/40 mix by over 4%, below both the equity and the bond component returns! This period was very disappointing for convertible investors but looking at the low level of volatility, it was also no surprise.

Next, we examine the more recent period starting January 1, 2019 to November 30, 2020. In this period, the average level of VIX rose beyond its long term average (around 20%) to 22.1% in an uncertain environment marked by the U.S. presidential election and COVID-19. In that period, MSCI Global stocks delivered an impressive annualized return of 20.12% while the Bloomberg Barclays Global Aggregate Total Return Index also did well with a return per annum of 10.13%. Here the 60/40 equity/bond mix delivered a return of 16.12%, which was attractive, but nevertheless was beaten by the Refinitiv Global Focus index which returned 16.54% per annum. The bottom line is that in a period of higher volatility, convertibles delivered a higher return than other fixed income categories due to the value of the option.

For 2021, our base case is that vaccines will become available, economic growth recovers and stocks do well. But we cannot count on a smooth ride. On the topic of vaccines, will be the efficacy of drugs approved in record time, who will get these treatments, and by when? Even assuming vaccines are the answer in 2021, it is still a significant question how steadily the global economy can rebuild when so much damage has been done. Which businesses will recover and which will fail? Can the consumer return to spending when so many people have lost their jobs? All of these questions pose challenges for the equity market, especially with record valuations in many sectors. We believe this makes an allocation to convertibles a prudent investment.

3. CONVERTIBLES VALUATIONS ARE AFFECTED BY TECHNICAL FACTORS

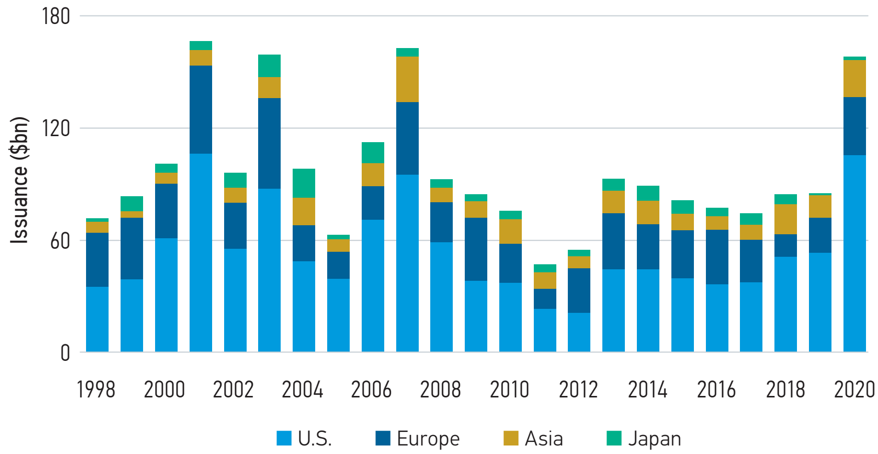
No review of 2020 or outlook for 2021 would be complete without mention of the dramatic supply story in the global convertibles market. After several years of below average issuance due to low rates and low volatility, supply took off in 2020, with $142bn in new paper, the highest total since 2007 (see *Display 5*). For the first time in several years, the total size of the convertibles market is now close to $500bn in size as the market grew by circa 30% in 2020. Such a large change creates a range of near term opportunities:

- **CHEAPNESS AS SUPPLY EXCEEDS DEMAND:** The heavy supply is only starting to be matched by a growth in demand, so convertibles market prices have traded as much as 4% cheap in some regions during parts of 2020. Even as stocks rallied strongly in November, the convertibles market is still between fair value to 1.5% cheap across different regions.[4] This is striking as convertibles nearly always richen when stocks rise as investors add risk. But in 2020, convertibles were slow to gain demand, making the asset class one of the few where pricing is not squeezed.
- **CHEAPNESS COMPARED TO LISTED OPTIONS:** The cheapness in the convertibles market looks an outlier to listed options where investors see a more volatile road ahead. Recent options research shows S&P 12-month implied volatility at its 83rd percentile for **richness** over five years[5] while convertibles research shows the convertibles market coincidentally at its 83rd percentile for **cheapness** since 2009.[6]

DISPLAY 5

In 2020, Convertible Issues Reached Highest Levels in a Decade

Global issuance has totaled $142bn YTD, the most since 2007's $163bn, driven by the US's $95bn



Source: BOAML, as of November 30, 2020

- **ATTRACTIVE DEAL TERMS FROM DISTRESSED SECTORS:** Much of the supply glut that came in 2020 occurred after the equity market selloff in Q1. This makes sense as badly affected firms needed to raise funding to get through the pandemic (e.g. airlines, cruise liners, traditional retail). The convertible market is always a popular choice in times of market distress because the elevated level of volatility raises option values, helping to offset widening credit spreads. Issuance at times of distress tends to be very good for investors in the long run because issuance terms need to be in the investors' favour, where conversion prices are set at lower premiums and off cheap stock prices.
- **SUPPLY FROM FIRMS THAT BENEFIT FROM THE PANDEMIC:** In addition to supply from distressed sectors that provide upside potential in an eventual pandemic recovery, the convertible market also had issuance from "covid-winners" in the technology and communications space who raised money to fund growth. The combination of supply from pandemic winners and losers both contributed to strong asset class returns in Q4.20. Many of these new issues have now priced up strongly and are no longer balanced, but there are still plenty of good opportunities.

Summary

The volatility created by the pandemic has clearly boosted the convertible bond market through benefitting the largest sectors, bringing significant new supply and keeping valuations in check. For the three years of 2015-2018, low growth and low volatility made convertibles look poor against both stocks and bonds. But now, we believe credit investors should consider adding convertibles as a highly diversifying asset that is ideally positioned to add return potential from economic recovery, and equity investors will want to consider convertibles as an opportunity to be paid for the volatility that will likely come from the rocky road to recovery.

[4] Source: Jefferies, as of December 11, 2020
[5] Source: UBS derivatives research December 7, 2020
[6] Source: BAML "Global convertibles Year Ahead" November 30, 2020

Risk Considerations

There is no assurance that a Portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the Portfolio will decline and that the value of Portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this Portfolio. Please be aware that this Portfolio may be subject to certain additional risks. **Fixed income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. In addition to the risks associated with common stocks, investments in **convertible securities** are subject to the risks associated with fixed-income securities, namely credit, price and interest-rate risks. In general, **equity securities'** values also fluctuate in response to activities specific to a company. Investments in foreign markets entail special risks such as currency, political, economic, and market risks.

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The **Bloomberg Barclays Global Aggregate Index** provides a broad-based measure of the global investment grade fixed-rate debt markets. Total Returns shown in unhedged USD.

The **Chicago Board Options Exchange (CBOE) Market Volatility (VIX) Index** shows the market's expectation of 30-day volatility.

The **MSCI World Index** is a free float adjusted market capitalization weighted index that is designed to measure the global equity market performance of developed markets. The term "free float" represents the portion of shares outstanding that are deemed to be available for purchase in the public equity markets by investors. The performance of the Index is listed in U.S. dollars and assumes reinvestment of net dividends.

The **MSCI World Health Care Index** is a capitalization weighted index that monitors the performance of health care stocks from developed market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

The **MSCI World Industrials Index** is designed to capture the large and mid-cap segments across 23 Developed Markets (DM) countries around the world. All securities in the indices are classified in the Industrials sectors, respectively, as per the Global Industry Classification Standard (GICS®).

The **MSCI World Information Technology Index** is a capitalization weighted index that monitors the performance of information technology stocks from developed market countries in North America, Europe and the Asia/Pacific Region. The index includes reinvestment of dividends, net of foreign withholding taxes.

The **MSCI World Consumer Staples Index** is designed to capture the large and mid-cap segments across 23 Developed Markets (DM) countries around the world. All securities in the indices are classified in the Consumer Staples sectors, respectively, as per the Global Industry Classification Standard (GICS®).

The **Refinitiv Convertible Global Focus USD Hedged Index** is a market weighted index with a minimum size for inclusion of $500 million (US), 200 million (Europe), 22 billion Yen, and $275 million (Other) of Convertible Bonds with an Equity Link.

The **S&P 500® Index (U.S. S&P 500)** measures the performance of the large-cap segment of the U.S. equities market, covering approximately 75 percent of the U.S. equities market. The index includes 500 leading companies in leading industries of the U.S. economy.

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