

“One of These Things is not Like the Others”

A Survey of the Financials Sector

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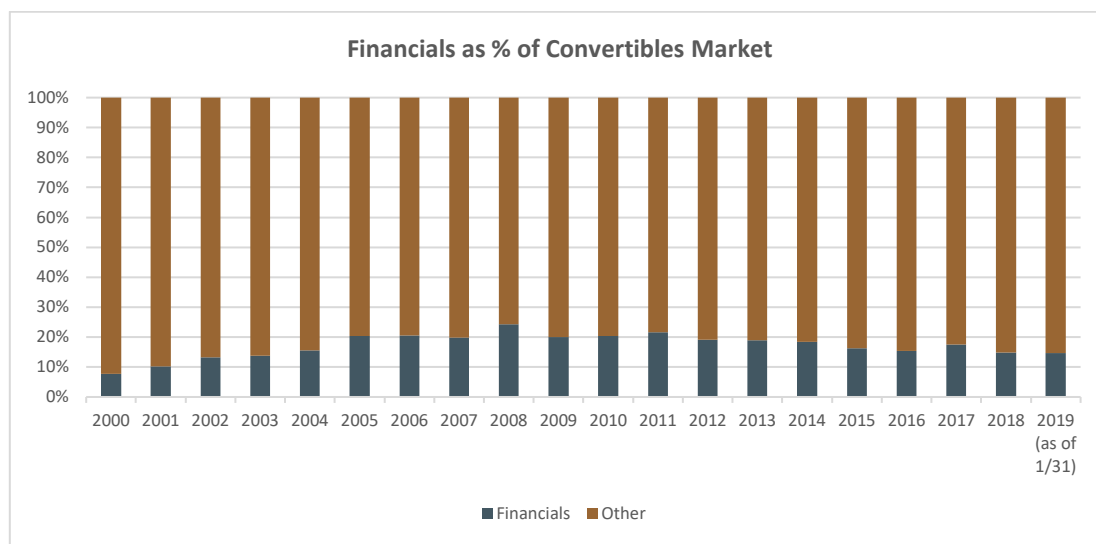
In the song popularized by the television program Sesame Street, viewers would be shown a group of items, one of which was different from the others, and have to identify the one which didn't belong. In a similar vein, amongst convertibles market sectors, the Financials sector stands out from the others on a variety of metrics, namely higher yield, higher conversion premium, and lower equity sensitivity than the overall market. These attributes provide current income and diversification in a market that is dominated by high growth technology and healthcare companies. In this article we provide an overview of the group.

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Financials – Third Largest Sector (14%) of the Convertibles Universe

The Financials sector peaked at 24% of the market in 2008 during the global financial crisis (as shown in Chart 1 below). Since then the sector has experienced underperformance and spotty new issuance, and now ranks third at 14% of the market, behind Technology (38%) and Healthcare (17%).¹

Chart 1: Financials as % of the Convertible Market



Source: BofA ML Global Convertible Chartbook (Feb 2019)

On the following page, Chart 2 demonstrates that just as with equities, post tech bubble outperformance of Financials has given way to underperformance since the global financial crisis.

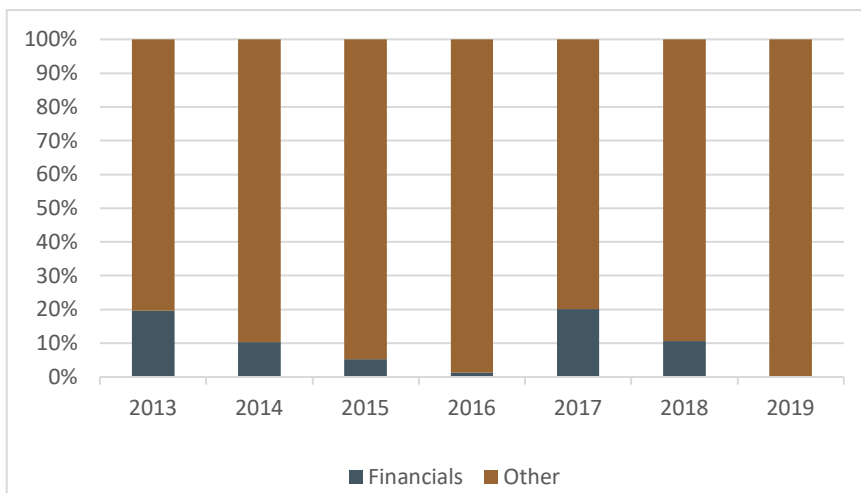
Chart 2: Financials Performance since Global Financial Crisis



Source: Bloomberg. "Convertible Market" (orange line above) represented by ICE BofA ML All US Convertible Index (VXA0). The white line shows the Financials sector.

With Technology and Healthcare new issuance dominating, Financials' new issuance has averaged 11%² of the primary market over the past five years – a far cry from 2008 when financial institutions comprised 62%³ of the primary market in a bid to shore up their balance sheets (see Chart 3 below).

Chart 3: Financials Share of Primary Market



Source: ICE BofA ML Chartbook as of 1/31/2019

Financials Sector Characteristics versus Convertibles Market

Chart 4 below compares the Financials sector versus the ICE BofA ML All US Convertibles Index (VXA0). The Financials sector differs considerably from the broad market in that 79% of issues are yield alternatives - current yield is double that of the market, and the equity sensitivity, as measured by effective delta, is just 20% as opposed to 56% for the market. This means that, on average, a \$1 move in the underlying stocks in the Financials sector will move the corresponding convertibles by just \$0.20 as opposed to \$0.56 for the overall market. Thus, in a portfolio context, Financials primarily serve to provide current yield in the portfolio and potential stability in volatile markets.

Chart 4: Financials Sector Characteristics vs. ICE BofA ML All US Convertibles Index (VXA0)

	ICE BofA ML Financials	ICE BofA ML All US Convertible Index (VXA0)	Comparison Financials vs. All Convertibles
# of Securities	82	407	20.2%
Market value (\$Bn)	26.5	184.7	14.3%
Face value (\$Bn)	23.6	156.9	15.1%
Price % of Par	112.3	116.3	-4.0
% Yield Alternatives	79.0	33.0	46.0
% Total Return	14.6	36.8	-22.2
% Equity Alternatives	6.4	30.2	-23.8
Current Yield (%)	5.1	2.5	2.5
Conv Premium (%)	47.7	41.7	6.0
Effective Delta (%)	20.3	56.1	-35.8
Avg. Credit Quality:	BB+	BB-	--

Source: SSI internal research; ICE BofA Merrill Lynch (as of 2/28/2019)

Underlying Equities Selected Characteristics

Convertibles in the Financials Sector provide exposure to underlying stocks with value characteristics, including lower than market price-to-earnings ratios and lower price-to-book multiples (as shown in Chart 5 below).

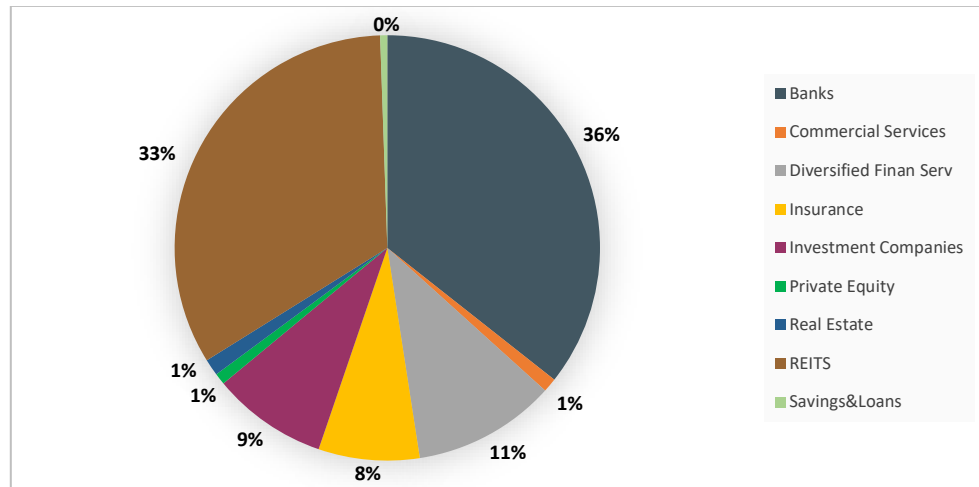
Chart 5: Financials vs. Overall Convertibles' Market Price-to-Earnings and Price-to-Book Comparison

	ICE BofA ML Financials	ICE BofA ML All US Convertible Index (VXA0)
Forward 12M P/E	9.3	29
Price to Book	1.2	2.8

Source: Bloomberg (as of 2/28/2018)

Financials Convertibles by Industry

Chart 6: Financials by Industry Percentage (%)



Source: SSI internal research; ICE BofA Merrill Lynch

Chart 6 above demonstrates how the Financials sector is concentrated with banks, primarily large convertible preferred issues by Wells Fargo & Co. and Bank of America Corp., representing 36% of total Financials issues, and Real Estate Investment Trusts (REITs), representing 33% of the sector. Business Development Companies (BDCs) and Insurance companies are also represented in the group.

Financials Sector Portfolio Highlights

Bank of America Corp. 7.25% perpetual convertible preferred- a yield alternative

A large, liquid (\$4 billion market value), investment grade (Baa3 / BBB-) issue with a 5.5% current yield. This provider of banking, capital markets, and wealth management services originally issued this preferred in 2008 with a conversion price of \$50 / share. With Bank of America common stock trading at \$29.50, well below the conversion price, the preferred has very little equity sensitivity, but is an attractive source of current income in a convertibles portfolio.

AXA Equitable Holdings Inc. mandatory convertible preferred 7.25% maturing 2021- total return alternative

The \$863 million mandatory convertible issued by this provider of retirement and investment management services sports a handsome yield advantage over the company's common stock and an attractive risk / reward profile. Share buybacks and other margin expansion initiatives may help the company achieve its earnings growth targets in 2019.

Conclusion

While the Financials sector of the convertibles market is clearly not like the others, it remains important due to its size and diversifying characteristics. With a higher than overall market current yield, and lower than

market equity sensitivity, the Financials sector provides income and potential portfolio ballast in volatile markets. The underlying equities in the sector display value characteristics, which provide additional potential diversification benefit in a market dominated by growth companies.

¹Source: SSI internal research; ICE BofA Merrill Lynch

²Barclays Live

³Ibid

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