FRANKLIN TEMPLETON INVESTMENTS

Topic Paper
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The Case for Global Convertibles

PERSPECTIVE FROM FRANKLIN EQUITY GROUP

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Bond-Equity Hybrids Let Investors Keep Their Options Open

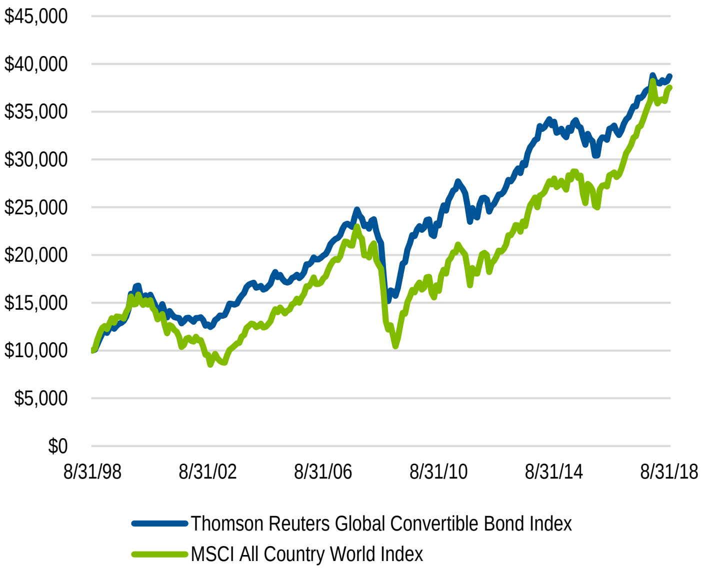
Convertible securities are a unique asset class in the investment world, offering investors both the growth potential of common stocks and the income offered by bonds. Issued by companies looking to raise capital, these hybrid investments are generally structured as some form of debt (bonds, debentures) or preferred shares with an embedded option that allows conversion into common shares under predetermined conditions.

The debt features of convertibles stem from the interest payments and claim to principal. In this respect, convertibles are similar to bonds and characteristically are typically expected to provide better protection against erosion of value in declining markets than the underlying common stock. But they are also similar to stocks because their embedded conversion component allows investors to participate in the stock's price appreciation.

If a company's common stock rises, the convertible security should increase in value because of the conversion option. If the common stock does not perform well, the fixed income component provides potentially better protection against losses than would the common stock alone. Because of these unique characteristics, convertibles may be classified as fixed income securities, equity securities or as a separate asset class.

Convertibles are attractive in low interest-rate environments when sources of income may be scarce. Historically, they have tended to perform well during periods of above-average market volatility, when cautious investors with a generally positive view of the equity markets seek risk-controlled equity exposure to reduce potential downside risk. Rising stock markets also favour convertibles due to the price relationship with the underlying common stock. We believe this ability to adapt to myriad market conditions makes convertibles an attractive vehicle for increasing a portfolio's level of diversification.

Exhibit 1: Convertibles Performance in Varying Market Conditions
Growth of a US$10,000 Investment
20 Years Ended 31 August 2018



Source: Morningstar. **Past performance does not guarantee future results.** The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.

Why Companies Issue Convertibles

Convertibles allow companies to finance activities through a lower-cost form of debt that offers less potential dilution to the common shares than selling common stock.

Advantages to the issuer include:

- Lower interest payments relative to straight debt
- Less potential share dilution compared to equity issuance
- Equity issued at a premium to the current stock price
- Ability to reach a broader range of investors

Within a company's capital structure, convertibles can be ranked at various levels of seniority ranging from the most junior preferred stock to senior secured debt. Most convertibles are issued as senior unsecured debt, which ranks higher than stocks with respect to income distribution or liquidation.

Anatomy of a Convertible

Convertibles possess a distinct structure that includes characteristics that may be unfamiliar to some investors such as the conversion ratio, parity, conversion premium, delta and gamma (Exhibit 2).

Conversion ratio sets out the number of common shares due upon conversion to the underlying stock. The conversion price, which is calculated by dividing the price of the convertible at issue by the conversion ratio, determines the price of the underlying common stock that is required for conversion. Generally, the conversion price is set upon issuance at a premium of anywhere from 15% to 50% relative to the price of the underlying common stock, with 20% to 30% being the most typical range.

Parity refers to the value of the convertible upon conversion. It is calculated by multiplying the conversion ratio by the current stock price.

Conversion premium is the value by which the price of the convertible exceeds its parity and is calculated as a percentage of parity.

Delta measures the sensitivity of the convertible price to changes in the price of the underlying common stock.

Gamma measures the sensitivity of delta to changes in the price of the underlying common stock. Convertibles tend to have lower gamma as their delta becomes very high or very low.

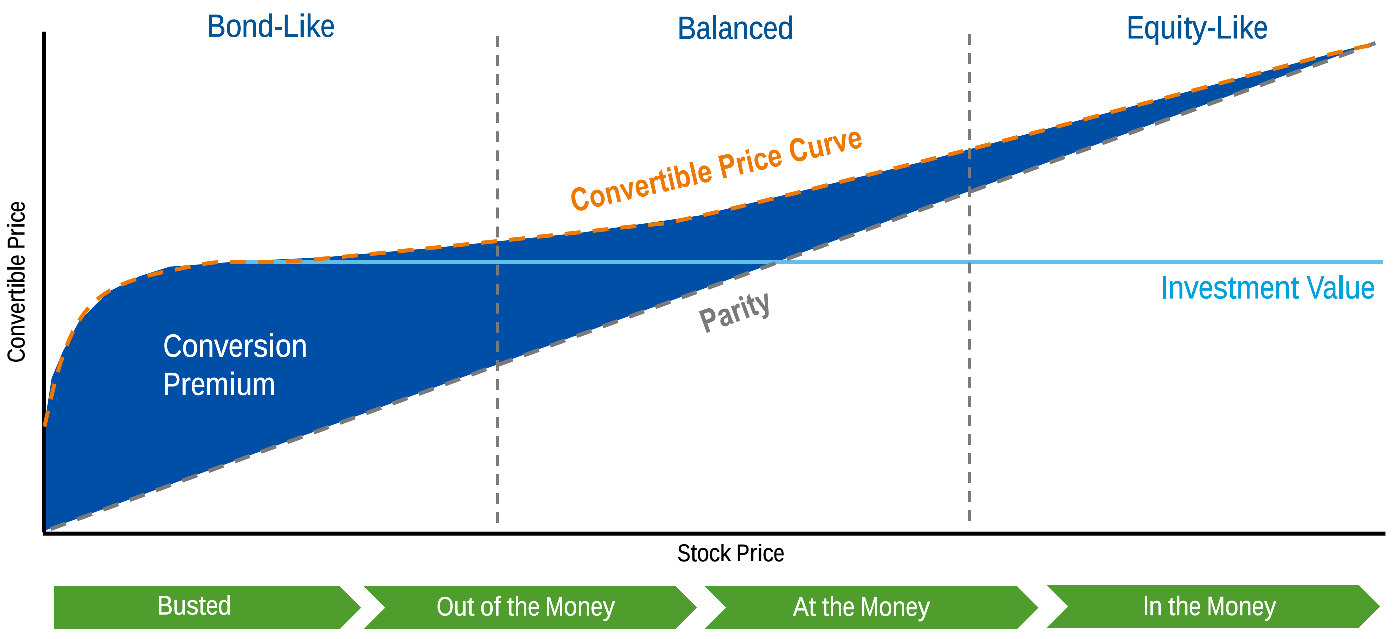
Busted, Balanced or Equity-Like?

Based on the conversion premium, convertibles can be broken down into three distinct categories: busted, equity-like and balanced.

Bond-like or **"busted"** convertibles are "out of the money"; they have a high conversion premium. Because the conversion price is substantially greater than the equity price, the conversion option is unlikely to be exercised. Busted convertibles have less sensitivity to the movement of the underlying common stock. Similar to bonds, they provide income and protection during market declines but offer less potential for upside participation.

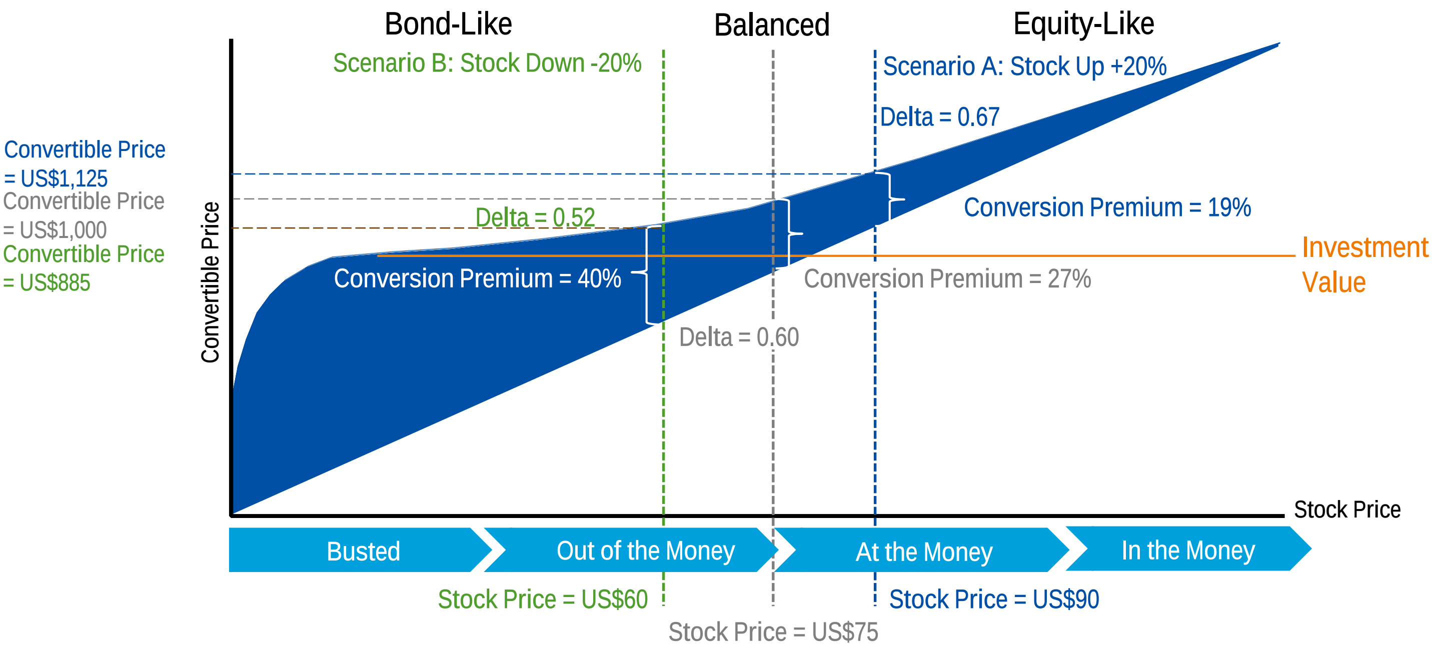
At the other end of the spectrum are **equity-like** "in the money" convertibles. Their conversion price is equal to or less than the equity price, which results in higher sensitivity to the stock price. Because equity-like convertibles closely track the underlying stock, they can offer greater upside potential; however, this also means they are almost as volatile as the underlying stock.

Exhibit 2: Types of Convertible Securities



The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.

Exhibit 3: Price Behaviour of a Convertible



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Balanced convertibles tread the middle ground with a moderate level of conversion premium and equity sensitivity. One of their typical primary advantages is an asymmetric risk/return profile, which can result in greater potential for participation in the upside return of the underlying stock and lower participation in the stock's downside return.

Exhibit 4: Stock Movement Effect on Convertible

	Stock Price at US$75	Scenario A	Scenario B
Stock Price	US$75	US$90	US$60
Convertible Price	US$1,000	US$1,125	US$885
Current Yield	3%	2.70%	3.40%
Parity	US$787.50	US$945.00	US$630.00
Conversion Premium	27%	19%	40%
Delta	0.6	0.67	0.52
Convertible Price Return	—	12.50%	-11.50%
Stock Price Return	—	20%	-20%
Convertible Total Return	—	14%	-10%
Convertible Upside/Downside Participation	—	70%	50%

The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio.

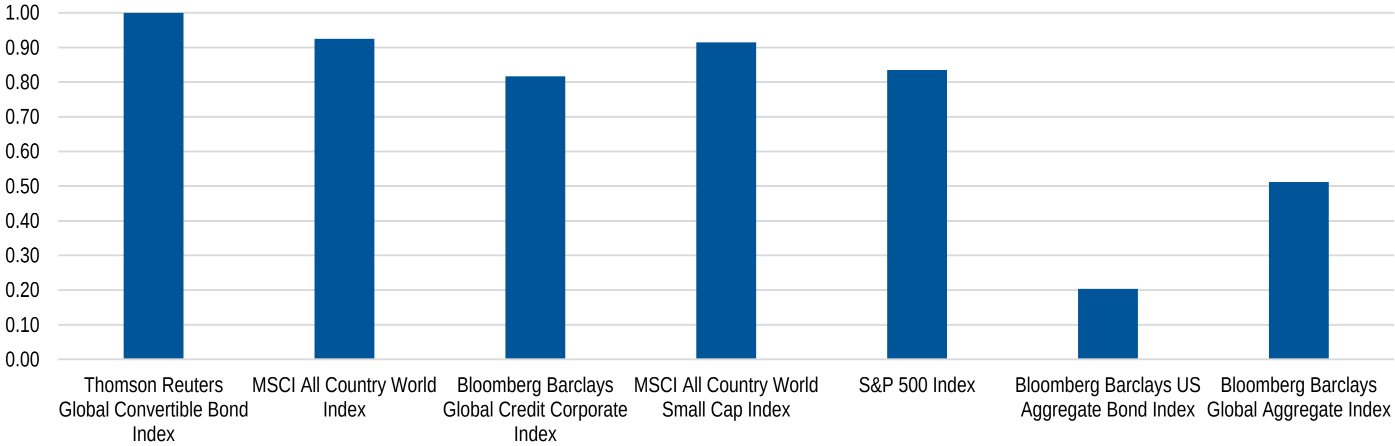
EXAMPLE

XYZ Corp. issues a three-year convertible bond with a US$1,000 par value and a semiannual coupon of 1.5%. The conversion ratio is 10.5, making the effective conversion price US$95.24 per share (US$1,000 ÷ 10.5 = US$95.24). The investor receives US$7.5 in income twice a year (US$1,000 x 1.5% ÷ 2 = US$7.5), for total income of US$15 each year. Today, the common share price is US$75 and the convertible price is US$1,000. The common stock pays no dividend. What happens to the convertible as the price of the underlying stock increases (Scenario A) or decreases (Scenario B)?

Scenario A. With a US$75 stock price and a US$1,000 convertible price, the conversion premium is 27% ([US$1,000 ÷ US$75 x 10.5] – 1 = 27%). Suppose the underlying equity increases by 20% to US$90 over a period of 12 months. This will generally lead to an increase in the convertible price, since conversion becomes more attractive and likely with the common stock price appreciation. Say the convertible price increases to US$1,125. In this case, the convertible price return is +12.5% ([US$1,125 ÷ US$1,000] – 1 = 12.5%). Including the coupon payments of US$15 (two semiannual coupon payments of US$7.5) leads to a total convertible return of 14%. Thus, the convertible delivered 70% of the stock price appreciation (14.0% ÷ 20.0% = 70%). Generally, as the stock price approaches the conversion price, the conversion premium declines and equity sensitivity (delta) rises.

Scenario B. Suppose instead that the stock price falls 20% to US$60. The convertible price will generally decrease as well, since the underlying common stock price depreciation makes the conversion option less valuable. Let's say the convertible price declines 11.5% to US$885. The convertible's total return is -10.0% ([US$885 + US$15 – US$1,000] ÷ 1,000 = -10.0%), compared to the stock's total return of -20.0%. In this case, the downward movement in the convertible price is half the change in the stock price, highlighting the convertible's defensive profile relative to the underlying common stock. Exhibit 4 summarises the change in the characteristics.

Exhibit 5: 15-Year Correlation of Global Convertibles to Select Asset Classes
As at 31 August 2018



Source: Morningstar. Past performance does not guarantee future results.

Four Good Reasons to Invest in Convertibles

Current Income. Investors seeking yield from equity securities may find convertibles an appealing option, as they generally provide a more attractive income component than stocks alone (although generally lower than straight bonds), while still allowing participation in the stock's price movement.

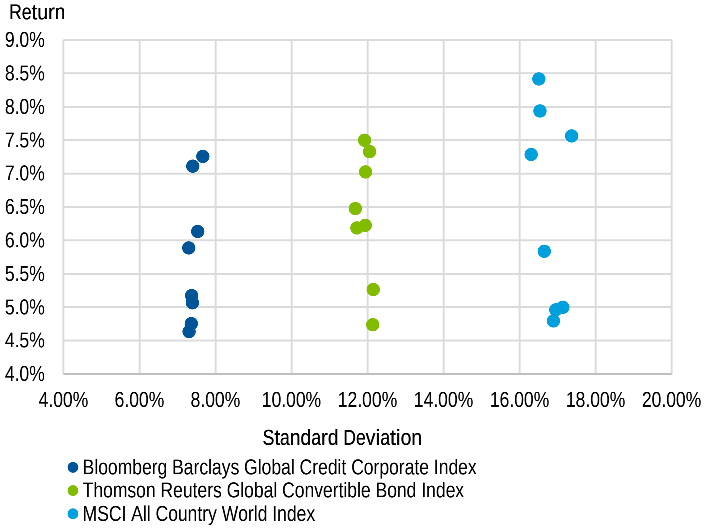
Potentially Attractive Risk/Reward Profile. Historically, convertibles typically have exhibited a low correlation to fixed income and demonstrated imperfect correlation with stocks. This creates potential for an investor to enhance diversification, dampen volatility and improve a portfolio's overall risk profile (Exhibit 5).

Attractive Potential for Long-Term Risk-Adjusted Returns. Critics point out that convertibles do not increase as rapidly in value as stocks during rising markets; nor does their downside protection equal that of bonds during market declines. Nevertheless, historically they have delivered attractive long-term risk-adjusted returns compared to both stocks and bonds (Exhibit 6).

Exhibit 7 further illustrates global convertibles' risk/return profile. Convertibles (the dark blue dot) have a beta and return profile that sits between the equity market (as measured by the MSCI All Country World Index, the green dot on the chart) and the bond market (as measured by the Bloomberg Barclays Global Corporate Credit Index, the light blue dot on the chart).

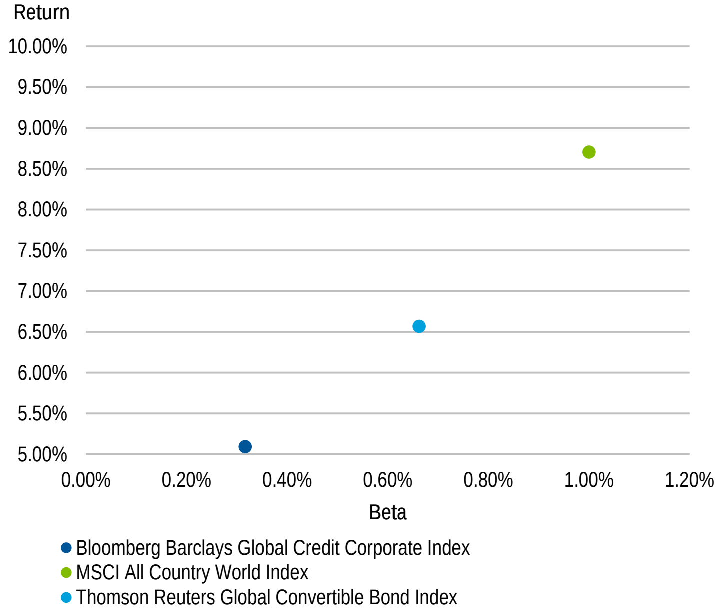
Robust and Diverse Opportunity Set. The flexible nature of convertibles could make them appealing to a broad range of investors. As a group, convertibles have historically presented an attractive risk/reward profile, but within the group there is considerable variation in the level of risk, sensitivity to movements in the underlying stock, and upside participation. Not only are these securities diversified across credit ratings, sectors, market capitalisation and investment characteristics, they are available worldwide.

Exhibit 6: Convertibles' Risk/Reward Profile Compared to Stocks and Bonds
As at 31 August 2018



Source: Morningstar. Rolling 10-year periods with one-year shift. Past performance does not guarantee future results. This chart is for illustrative purposes only and does not represent the performance of any Franklin Templeton fund. Risk as measured by standard deviation.

Exhibit 7: Low Beta Equity Exposure
15-Years Ended 31 August 2018



Source: Morningstar. Beta is measured against the MSCI All Country World Index. Past performance does not guarantee future results.

Exhibit 8: Profile by Region
As at 31 August 2018

	Market Value (Billion)	Amount Outstanding (Billion)	Number of Issues	Number of Issues %	Current Yield	Conversion Premium	Average Credit Quality	Delta
Global Convertibles	US$366	US$319	750	100%	1.98%	29.00%	BAA3/BA1	0.57
United States	US$228	US$189	476	63%	2.55%	26.13%	BA1/BA2	0.66
EMEA	US$93	US$89	167	22%	1.33%	37.89%	BAA1/BAA2	0.42
Asia ex Japan	US$25	US$25	53	7%	0.75%	33.53%	BAA2/BAA3	0.34
Japan	US$19	US$17	54	7%	0.00%	18.91%	BAA1/BAA2	0.51

Source: Barclays. The above is a hypothetical example used solely for illustrative purposes. It does not represent securities of an actual account or portfolio. Current Yield: In general, yield is the annual rate of return for any investment and is expressed as a percentage. With bonds, yield is the effective rate of interest paid on a bond, calculated by the coupon rate divided by the bond's market price. Bonds are typically issued with fixed coupon payments (regular cash payments of a fixed amount). Bonds are typically valued in terms of the their yield—what dollar amount as coupon payments is received as compared to the bond's current market price. For a bond fund the current yield may be the disclosed yield paid out to investors. Current yield, conversion premium, average credit quality and delta data points are using the G300 Convertibles Index.

Taking It Global

With a value of over US$360 billion in the third quarter of 2018, the global convertible securities market is a sizeable player in the world's capital markets. The United States accounts for over half that amount, followed by the Europe, Middle East, Africa (EMEA) and Asia-Pacific regions, respectively (Exhibit 8).

Perhaps more important is the ample room for growth. Following a peak in 2007, issuance declined as companies took advantage of low yields, a high equity risk premium relative to credit spreads and strong flows into the credit markets to issue straight debt rather than convertibles. The perception was that raising capital through straight debt was relatively cheap, even when convertible securities were issued at slightly lower rates due to the added concern of share dilution. Companies were also hesitant to issue convertible securities as equity valuations were inexpensive relative to historical levels. As at September 2018 we have seen stronger issuance figures year-to date, on pace to exceed the last several years, driven by better equity market performance, a rise in interest rates and higher spreads.

Potential catalysts for increased issuance include:

- Continued increases in US interest rates which may lead companies to prefer more cost-effective means of raising capital (such as convertibles) than straightforward debt, particularly as equity valuations have been near or at historical highs for many issuers
- A secular shift in Europe from loan to bond financing and high funding cost for high-yield issuers
- Refinancing of existing convertibles in the Asia-Pacific region

Reducing Risk through Portfolio Construction

Some investors may have concerns about the credit profile of a convertible issuer. Active portfolio management, fundamental research and a bottom-up approach to security selection can be used to help address these concerns by targeting companies with rising credit profiles. While default risk is an important factor when evaluating securities, many other elements must be considered before making an investment, such as business fundamentals, asset and cash flow coverage of debt and fixed costs, and the likelihood of improvement in the underlying credit profile.

Convertibles: An All-Weather Investment

Although past historical performance cannot guarantee future results, global convertibles, based on historical characteristics, offer the potential for low correlation to other asset classes, a broad universe of opportunities, and exposure to emerging as well as developed regions, which may help to reduce risk through portfolio diversification.

Convertible securities can provide opportunities for investors to "hedge their bets" by providing characteristics of both the fixed income and equity markets. For those seeking income and risk-managed equity exposure, these investments offer numerous potential benefits, including:

- Current income that is usually higher than a stock's dividend
- Upside participation in the underlying common stock's price with less downside risk
- Typically less volatility than the underlying common stock alone
- Additional diversification potential and a means that seeks to improve the risk/reward profile in a portfolio
- A claim on the issuer's assets senior to holders of common shares

Worldwide, convertible securities are garnering increasing attention from both issuers and investors. The asset class has ample room for expansion as companies across the globe look for financing and endeavor to attract investors to their common shares at the lowest possible cost. We believe higher levels of creditworthiness in the developing markets and fiscally healthy companies in the developed markets point to abundant opportunities for participating in corporate growth, even in uncertain markets—possibly the strongest argument for including a component of global convertible securities in a diversified portfolio of investments.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Generally, those offering potential for higher returns are accompanied by a higher degree of risk. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of a portfolio may decline. High yields reflect the higher credit risk associated with these lower-rated securities and, in some cases, the lower market prices for these instruments. Convertible securities are subject to the risks of stocks when the underlying stock price is high relative to the conversion price (because more of the security's value resides in the conversion feature) and debt securities when the underlying stock price is low relative to the conversion price (because the conversion feature is less valuable). A convertible security is not as sensitive to interest rate changes as a similar non-convertible debt security, and generally has less potential for gain or loss than the underlying stock.

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