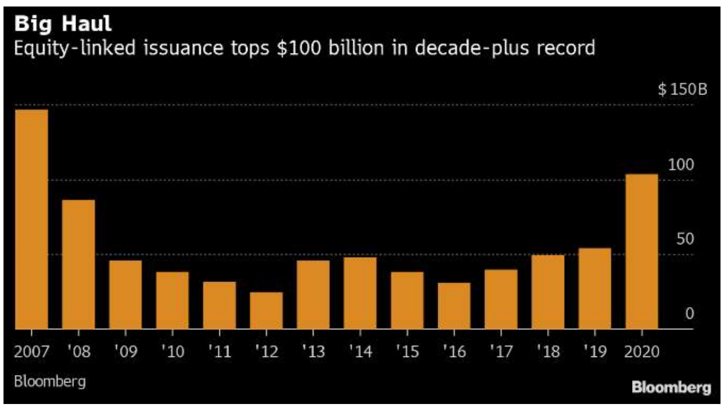
APTUS CAPITAL ADVISORS

Convertible Bonds…Feed the Ducks

Convertible bonds (CBs) represent an exciting but often neglected section of the fixed income markets. Companies raise capital to fund growth, acquisitions or operations largely through two options: equity or debt and in certain situations a hybrid, convertible notes. While there are gives and takes to all external financing sources, as capital is a scarce resource, companies must choose the source that makes the most financial sense for the company and shareholders.

We'd argue that right now companies might have the greatest opportunity to raise capital in the convertible space at borderline ludicrous levels coming at practically no cost. Although we don't consider investing a zero-sum game, what's good for one party (the company) in this situation is likely bad for the other (the investor).

Why Companies issue Convertible Notes

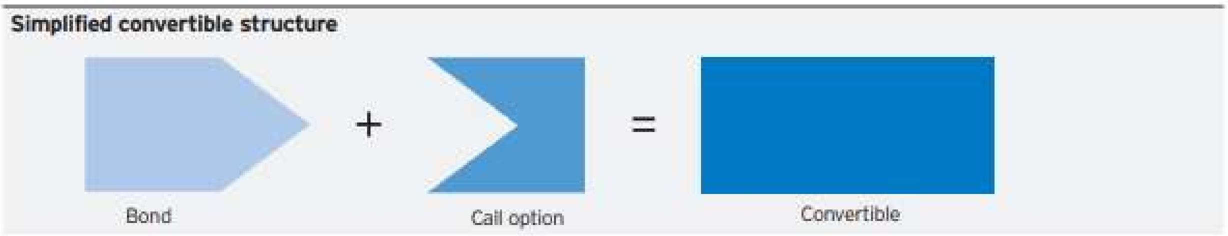


Source: Bloomberg as of 12/31/20

- Lower interest rates on debt– investors accept lower yields for potential equity upside
- Delay share dilution – interest expense is tax deductible in the near term and dilution is delayed as the company (hopefully) grows net income and its share price over the life of the CB.
- Ability to force conversion and redeem the bond in the event share prices move higher or interest rates fall, and they can reissue at better terms (companies typically have a call feature)

265 Young Street | Fairhope, AL 36532 | 251.517.7198 | info@aptuscapitaladvisors.com

Convertible securities offer a hybrid exposure that pair a bond with an equity kicker which can help participate in equity market upside while potentially offering some downside protection due to the bond like characteristics. The convertible structure can generally be simplified to the graphic below:



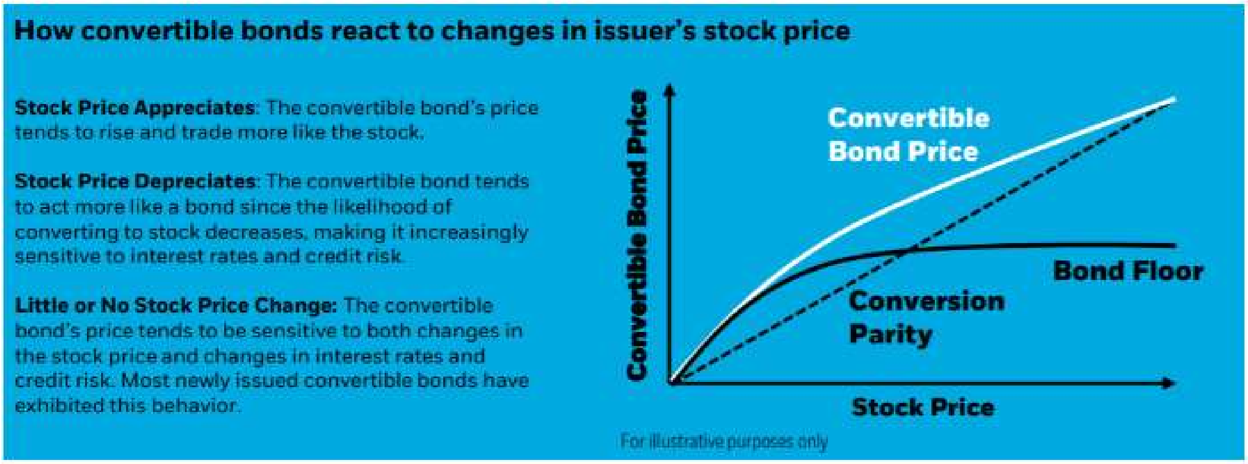
Source: BofA Merrill Lynch Convertible Research.

Typically, a convertible security is a bond that can be exchanged or converted into a specific number of shares of the issuer's common stock. The conversion ratio is set at issuance and can typically be exercised by the holder.

Recent Performance

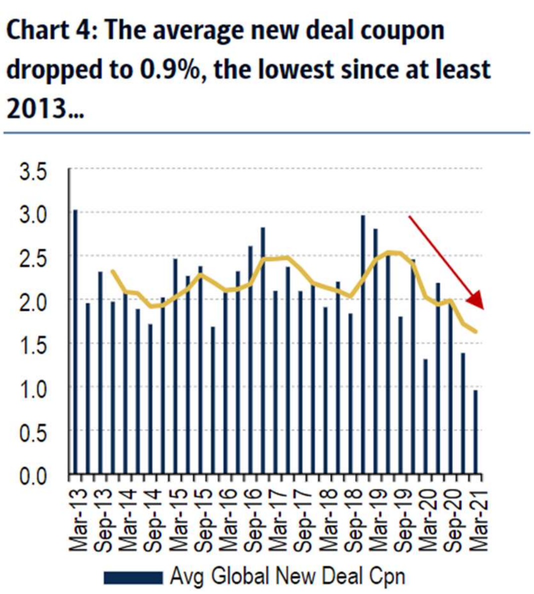
Convertible Bonds experienced an incredible 2020 and start to 2021. The Bloomberg Convertible Index outperformed both the S&P 500 and Nasdaq indices in 2020. We can't mention CB's without highlighting Tesla which attributed approximately half of the 2020 convertible bond index return in 2020. The Bloomberg Convertible Index is off to a hot start in 2021, up over 10% through 2/16/21.

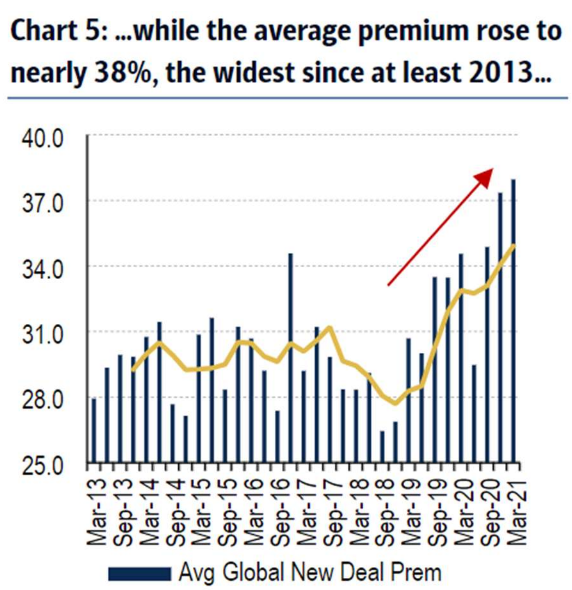
Convertibles In Action



Source: Blackrock (ICVT Factsheet)

Where this gets Worrisome





Source: BofA Global Research as of January,2021

Many non-earning, ultra-growth companies have utilized the convertible market to take advantage of cheap financing and generous terms, and in recent times no interest costs. While zero or low interest rates have been common here recently, conversion premiums have increased substantially. The conversion premium refers to the appreciation required of the equity price in order for the investor to turn a profit. The higher the conversion premium, the greater the upside required to make money.

Convertibles in Investors' Portfolios

Breaking out the top holdings in the iShares Convertible Bond ETF (ticker: ICVT), there is significant concentration risk to high growth, non-earners. The top 11 holdings in ICVT make up over 17% of the fund. New ICVT investors are likely getting a different risk/ return profile than expected as many of the underlying holdings are trading significantly above the original conversion price. We believe this essentially gives investors a 1:1 long position on the underlying holdings with minimal downside protection in place.

Ticker	Issuer	Weight in ICVT ETF %	Coupon	Equity Price	Conversion Rate (Shares)	Conversion Price	- Premium at New Issue	Issur Call Cap	Parity	% Mkt Px Above Conversion Price	Potential Downside	P/E Multiple
TSLA	TESLA INC	4.68%	2.00	816.12	16.14	61.97	27.5%	1.3	1317.05	1317%	92%	1104x
SE	SEA LTD	1.83%	1.00	276.12	19.95	50.13	42.5%	1.3	550.79	551%	82%	Non- Earner
TSLA	TESLA INC	1.57%	2.38	816.12	15.27	65.50	25.0%	1.3	1245.97	1246%	92%	1104x
TSLA	TESLA INC	1.41%	1.25	816.12	13.89	71.97	42.5%	1.3	1133.92	1134%	91%	1104x
PDD	PINDUODUO INC	1.21%	0.00	196.59	23.47	42.61	37.5%	1.3	461.36	461%	78%	Non- Earner
SE	SEA LTD	1.19%	2.38	276.12	11.05	90.46	32.5%	1.3	305.25	305%	67%	Non- Earner
LUV	SOUTHWEST AIRLINES CO	1.14%	1.25	51.34	25.99	38.48	35.0%	1.3	133.44	133%	25%	Non- Earner
SNAP	SNAP INC	1.12%	0.75	61.97	43.85	22.81	40.0%	1.3	271.73	272%	63%	Non- Earner
BILI	BILIBILI INC	1.01%	1.38	153.12	40.40	24.75	37.5%	1.3	618.67	619%	84%	Non- Earner
Z	ZILLOW GROUP INC	1.00%	0.75	197.81	22.98	43.51	35.0%	1.3	454.63	455%	78%	Non- Earner
BILI	BILIBILI INC	0.99%	1.25	153.12	24.55	40.73	32.5%	1.3	375.93	376%	73%	Non- Earner

Source: Aptus Research as of: 2/12/21

Where this gets more concerning is the aggressiveness of pricing on the new issue market as companies flood the market with new issues at what we view as unfavorable pricing. For instance, Peloton’s new oversubscribed $875 million convertible deal came at a 65% conversion premium to the current equity price while paying no interest (0% coupon). These terms are nearly double the average conversion premium of 34%.

Ticker	Issuer	Weight in ICVT ETF %	Coupon	Equity Price	Conversion Rate (Shares)	Conversion Price	- Premium at New Issue	Issur Call Cap	Parity	% Mkt Px Above Conversion Price	Potential Downside	P/E Multiple
PTON	PELOTON INTERACTIVE INC	N/A	0.00	154.67	4.18	239.23	65.0%	1.3	64.65	-65%	0**	Non- Earner

Source: Aptus Research as of: 2/12/21

** Potential downside assumes Peloton is still in business and the equity price isn’t above the conversion price of $239.23 would be a return of Par Value at 2026 Maturity with no interest (0% coupon). There would be a loss of principal in this case the investor paid over Par for these securities.

Simply put, if purchased at new issue and Peloton stock doesn't rise above $239.2344 over the next 5 years, the investors best case is a return of principal with no interest attached. Talk about the potential for significant opportunity cost.

CONVERTIBLE BOND ANALYSIS

Press OVCV <GO> for Bloomberg's Convertible Bond Model Analysis

PELOTON INTERACT PTON 0 02/15/26 / (/) TRMT

SETTLEMENT DATE 2/17/2021 WORKOUT 2/15/2026 @ 100.000

BOND: PRICE	110.00000	DURATION (YEARS)	4.994
YIELD TO WORKOUT	-1.899	ACCRUED INTEREST/BOND	
STOCK: PTON PRICE	154.67	ANNUAL DIVIDEND	

CONVERSION TERMS

CONVERSION RATIO	4.180	<OR>	CONVERSION PRICE	239.23
CASH REQUIRED / 1000 FACE			DILUTION PROTECTION	%
RATE FOR COST OF CARRY (%)	0.05071		PROVISIONAL PRICE	311.00491
SHORT REBATE (%)	0.04057		HEDGE RATIO (%)	100
+ HAIRCUT (%) on stock	0		CASH REQUIRED FOR HEDGE	453.48

CURRENT YIELD BOND		PREMIUM POINTS	45.35
STOCK	0.00	PERCENT PREMIUM	70.14
ADVANTAGE	0.000	PARITY	64.65
NET CASH FLOW ($)/YR	-0.296 = -0.1 %	PROVISIONAL HEDGE	30.61
BREAK-EVENS YLD ADV.	******** (YRS)	BREAKEVEN P & L	-453.48
CASHFLOW	-1534.56 (YRS)		

Source: Bloomberg as of 2/15/21

Given the convertibles are now trading at a premium to par ($110), the stock price must rise even higher to above $263 in order for investors to just breakeven. Again, to simplify, investors are paying $110 for something currently worth $65, a 70% premium. To break this down further, because the investor gets the certainty of getting back the original par value of the note (unless default, of course), they give up all participation in Peloton's upside between the current market price of $155 and $263. Stated again, Peloton's stock price must appreciate by over 70% before maturity in 2026 for these notes to move into the money.

A Peek Back to the DotCom Bubble

Range 09/30/1998 - 09/29/2000 Period Daily No. of Period 730 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	ANNPX US Equity	USD	95.29%	103.43%		42.63%

Range 09/29/2000 - 09/30/2002 Period Daily No. of Period 731 Day(s) Table

	Security	Currency	Price Change	Total Return	Difference	Annual Eq
1)	ANNPX US Equity	USD	-47.14%	-39.79%		-22.38%

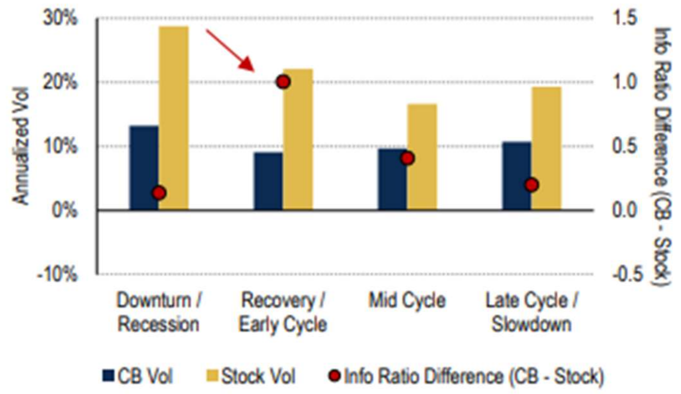
Source: Bloomberg

While we aren't calling today's market a bubble, this isn't the first time we've seen convertible bonds appear to get frothy. Over a two-year span from September 1998 through September 2000, the Virtus AllianzGI Convertible Fund (ticker: ANNPX) returned 103.43%. The following two years September 2000 through September 2002, the fund declined by nearly 40%. Keep in mind the fund was also yielding over 3% during the timeframe, substantially higher than the 0.69% currently.

Conclusion

While the new issue Peloton deal highlighted above is just one example, we'd consider extremely unfriendly to investors; we believe there are several signs emerging within the convertible market that show exuberance. When equity prices rise drastically, convertible bonds look more like their equity counterpart to the upside… but keep in mind they will also show similar equity-like volatility to the downside.

Chart 4: What's more, on a relative basis converts have outperformed their underlying stocks by the widest margin during "Recovery" phases



Source: BofA Global Research, ICE Data Indices, LLC. Data as of 18-Nov-2020. Information ratio is calculated as the average annualized return / annualized vol within each phase.

While we believe convertible bonds can add unique return profiles to investor portfolios, the timing and valuations are paramount. We actually recommend investors consider layering in convertible exposures after a deep market decline where the bond characteristics can help buffer further losses. We also believe companies are more susceptible to issue deals at favorable rates in periods of distress as volatility spikes – volatility is a key ingredient to the pricing of the equity kicker within convertible bonds.

Adding convertibles to allocations during times of market turmoil can position investors to clip income and potentially capture equity market upside as the market recovers while also incorporating minimized downside. The graphic above shows that convertibles tend to have favorable return to risk metrics during a recovery phase.

And that leads to our final point: context, valuation and timing are everything. Right now, given the backdrop of the convertible sector from a pricing perspective, we believe investors utilizing convertibles exposures in their portfolios, specifically in lieu of traditional fixed income, could be injecting significant risk into their clients' portfolio.

Disclosures

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