Invesco

**Asset Class Insights** | Convertible Securities

# Volatile first half leads to higher yields and cheaper valuations.

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**Overview**

- **Convertibles declined YTD but outperformed underlying equities.** Convertibles behaved as expected, capturing less downside than their underlying equities.
- **Amid the correction, yields have increased, and convertibles have cheapened.** The average yield is now 5.2%, and roughly 40% of the market is now considered credit sensitive according to Barclays as of June 30, 2022.
- **Volatility contributed to sluggish issuance.** Just $8.3 billion of new domestic issuance occurred in the first half of 2022, according to Bank of America as of June 30, 2022.

## A difficult first half for most asset classes

Equity markets declined sharply in the first half of 2022 as the US experienced the highest inflation in four decades. The Federal Reserve acted aggressively to curb rising inflation, raising the benchmark federal funds rate by 0.25% in March, 0.50% in May and by 0.75% in June, with additional increases expected in the second half of the year.[1] Longer-term bond yields also increased considerably, with the yield on the benchmark 10-year U.S. Treasury note touching 3.49% on June 14, its highest level in more than a decade.[2] Given higher rates, investors grew concerned about a potential recession in the second half and the potential impact on corporate earnings. At the same time, the ongoing Russian/Ukraine war and continued supply chain disruptions provided a difficult backdrop for risk assets.

The S&P 500 Index returned -19.96% for the first half of 2022, its worst six-month period since 1962.[3] Rising rates also punished high-growth stocks during the period, as investors tend to place less value on a company's future earnings. As a result, the NASDAQ composite suffered a sharp correction and entered bear market territory, declining -29.2% in the first half.[4] As rates rose, most broad fixed income indexes also declined, with the Bloomberg US Government/Credit index declined -11.0% and the Bloomberg US Corporate High Yield  index declined -14.2%.[4]

## New convertible issuance was the weakest first half on record

Amid rising rates and heightened volatility, global convertible issuance totaled just $11 billion, the slowest first half on record.[5] The bulk of issuance came from the US, which totaled $8.3 billion for the first six months of the year. That pace is far below the record US issuance in 2020 and 2021 which reached $68 billion $56 billion for the same period, respectively.[5] Compared to the prior two years, pricing and deal terms have become more favorable to buyers, with higher yields and lower premiums. Redemptions in the form of puts, calls and maturities outpaced new issuance, and net supply contracted by $20.1 billion in the US in the first half.[5]

## Convertible securities declined, but outperformed underlying equities

Convertible securities, as represented by the ICE BofA US Convertible Index returned -20.2% in the first half of 2022, driven by weakness in underlying equities, which returned -36.1%.[5] Underlying stocks and convertible securities sold off along with the correction in growth and tech equities, as issuers tend to be concentrated in the technology, health care and consumer discretionary sectors. These sectors comprise about 50% of the convertible universe and they suffered double-digit declines.[5] Conversely, energy was the only positive sector for the 6-month period, but it represents less than 5% of the index's market value.[5]

Predictably, equity sensitive convertibles underperformed, as these issues offer less convexity on the downside. Among these were some of the more aggressively priced issues that came to market in 2021. These issues tended to have low coupons and high premiums, resulting in steep declines. Large cap issuers underperformed small caps, and investment grade outperformed lower rated converts.

Given the sharp pullback in underlying equity shares, convertibles underperformed most other fixed income asset classes during the first half of the year. Still, the asset class is behaving as expected, meaning that convertibles fell less than their issuers' common stock, due to their fixed income component.

As a result of the selloff, convertible prices have cheapened on a theoretical basis, meaning that prices have declined relative to the credit strength of the bond's issuer and the volatility in the underlying stock. In fact, U.S. convertibles are approximately 2% undervalued, according to Bank of America, the cheapest they have been since the depths of the pandemic over two years ago.[6]

Convertibles yields have also increased. The average yield on a U.S. convertible bond has moved from 2.6%[7] at the start of the year to 5.2%[8] at the end of June, according to Barclays, with approximately 40% of the convertible market now considered "busted" or credit sensitive, almost double the percentage from the start of the year.[8] Credit sensitive/busted convertibles exhibit less equity sensitivity and more bond-like characteristics such as higher yields, higher conversion premium, and less downside risk relative to the common stock. These convertibles offer opportunities in volatile markets with cheap embedded call options, and investors get paid to wait for an eventual recovery as the bond accretes towards par value at maturity.

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**Invesco Convertible Securities Fund outperformed in the first half of 2022**

The fund's Class A shares at NAV declined -18.5% for the year-to-date period ending June 30, 2022, outperforming the ICE BofA US Convertible Index, which returned -20.2%. The fund benefitted from security selection and an overweight in energy, as it was the only sector to post a positive return for the first 6 months of 2022. Within energy, Pioneer Natural Resources and EQT were key contributors to relative performance. Security selection in consumer discretionary and technology also benefitted the fund, largely due to the avoidance of some weaker issues within these sectors. Selection in media also added to relative performance. The fund's relative underweight in Snapchat app developer Snap was a significant contributor. Exposure to non-US holdings NICE and Sea Limited also contributed to relative performance as these issues are not in the benchmark and held up better than the overall sector.

Security selection in financials was the largest detractor during the period, largely due to KKR, which sold off as the overall environment for private equity has become less favorable. Security selection and an underweight position in health care also detracted from relative returns, due in part to Avantor, which reported better-than-expected earnings during the period, but inflation and supply chain issues weighed on sentiment. We sold this position during the period.

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**Invesco Convertible Securities Fund: Historical Returns**
As of as of June 30, 2022

| **Average annual total returns (%)** | **YTD** | **1 Year** | **3 Years** | **5 Years** | **10 Years** | **Since Inception (07/28/97)** |
|---|---|---|---|---|---|---|
| Class A shares at NAV | -18.5 | -17.2 | 8.8 | 9.0 | 8.4 | 7.0 |
| Class A shares at 5.50% load | -23.0 | -21.8 | 6.8 | 7.8 | 7.8 | 6.8 |
| ICE BofA US Convertible Index | -20.2 | -20.6 | 10.1 | 10.0 | 10.6 | -- |

***Performance quoted is past performance and cannot guarantee comparable future results; current performance may be lower or higher. Visit invesco.com for the most recent month-end performance. Performance figures reflect reinvested distributions and changes in net asset value (NAV). Investment return and principal value will vary so that you may have a gain or a loss when you sell shares. Had fees not been waived and/or expenses reimbursed in the past, returns would have been lower. Performance shown at NAV does not include the applicable front-end sales charge, which would have reduced the performance.***

**Portfolio positioning**

During the period, we sold or exchanged higher priced convertibles where applicable and redeployed those assets into more balanced issues trading closer to par value. The fund's delta or equity sensitivity decreased to approximately 0.47 at the end of June, down from 0.67 at the start of the year. From a sector standpoint, we reduced the fund's exposure to technology and consumer discretionary and added to energy. We currently hold relative overweights in utilities and industrials and underweights in health care and consumer discretionary. Overall, we continue to limit the fund's concentration and single-issue risk. At the end of June, we owned about 110 issues in the strategy with our top ten holdings making up approximately 21% of the portfolio's assets.

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**Reasons for optimism in the second half of 2022**

Looking ahead to the second half, we expect continued volatility in the markets, at least until it is clear that inflation has peaked. While the Fed seeks to achieve a "soft landing," it appears that the US economy may soon be in a technical recession. We expect earnings downgrades as firms struggle with a slowing economy and rising cost pressures.  Ongoing supply chain issues, geopolitical tensions and the upcoming midterm elections could also weigh on markets.

Convertibles will not be immune to these headwinds, but we believe there are reasons for optimism. The increase in the number of credit sensitive convertibles has attracted interest from non-traditional buyers in the asset class, as investors normally focused on non-convertible debt are finding attractive yields combined with cheap, although out of the money, imbedded call options in convertibles. Additionally, many of these non-traditional investors are attracted by the opportunity to invest in companies not typically found in the traditional fixed income space, as nearly three-quarters of companies with outstanding convertibles don't have any non-convertible debt outstanding, according to Barclays.[9] We believe this could be supportive of the asset class going forward.

While the increased the cost of financing and weak equity prices have kept issuers on the sidelines so far, we believe that issuance may improve in the second half. High yield borrowers may turn to convertibles as the asset class is a relatively cheaper form of financing. We also believe that companies may buy back paper that is trading below par.

In our view, convertible valuations look much more attractive than they did at the beginning of the year. Our team continues to focus on what we believe is the "sweet spot" of the market – those convertibles that we believe may offer both upside participation should their underlying stocks rise and may offer downside support via the securities' fixed income attributes. Additionally, given the increase in the number of issues in the asset class now offering attractive yields, we are selectively adding credit sensitive bonds to the portfolio, which we believe may provide worthwhile returns and the potential for risk mitigation on the downside at lower prices.

## Footnotes

1 Source: US Federal Reserve, 7/2/22.
2 Source: US Treasury Department, 6/15/22
3 Sources: Morningstar Direct 6/30/22, BofA Global Research, 7/1/22.
4 Source: Morningstar Direct, 6/30/22.
5 Source: BofA Global Research, as of 6/30/22.
6 Source: BofA Global Research, ICE Data Indices LLC, as of 6/30/22.
7 Source: Barclays, as of 1/13/22
8 Source: Barclays, as of 6/30/22
9 Source: Barclays, as of 5/1722.

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## Definitions

A convertible security is an investment that can be changed into another form, such as convertible bonds that can be changed into common stock.

A put option (or “put”) gives an investor the right to sell a security at a specified price within a certain time frame.

A call option (or “call”) gives an investor the right to buy a security at a specified price within a certain time frame.

Par value is the price at which a bond was issued, also known as its face value. A bond's price will then fluctuate based on prevailing interest rates, time to maturity, and credit ratings, causing the bond to trade either at above par or below par. Par value for a bond is usually $1,000 (or sometimes $100), as these are the most common denominations in which they are issued

"Out of the money" is an expression used to describe an option contract that only contains extrinsic value.

Delta is the sensitivity of the price of a convertible bond to changes in the price of the underlying stock.

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**Invesco Convertible Securities Fund Top 10 Holdings**
As of June 30, 2022, % of total net assets

1. Broadcom, 2.53%
2. Microchip Technology , 2.48%
3. Pioneer Natural Resources, 2.40%
4. EQT, 2.31%
5. Palo Alto Networks, 2.30%
6. NextEra Energy, 2.07%
7. Wells Fargo, 2.03%
8. Bank of America, 1.99%
9. Becton Dickinson, 1.83%
10. NiSource, 1.77%

Holdings are subject to change and are not buy/sell recommendations.

## Important Information

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

Convertible securities may be affected by market interest rates, the risk of issuer default, the value of the underlying stock or the issuer's right to buy back the convertible securities.

An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Derivatives may be more volatile and less liquid than traditional investments and are subject to market, interest rate, credit, leverage, counterparty and management risks. An investment in a derivative could lose more than the cash amount invested.

The risks of investing in securities of foreign issuers, including emerging markets, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Junk bonds involve a greater risk of default or price changes due to changes in the issuer's credit quality. The values of junk bonds fluctuate more than those of high-quality bonds and can decline significantly over short time periods.

Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa.

Preferred securities may include provisions that permit the issuer to defer or omit distributions for a certain period of time and reporting the distribution for tax purposes may be required, even though the income may not have been received. Further, preferred securities may lose substantial value due to the omission or deferment of dividend payments.

To the extent an investment focuses on securities issued or guaranteed by companies in a particular industry, the investment's performance will depend on the overall condition of those industries, which may be affected by the following factors: the supply of short-term financing, changes in government regulation and interest rates, and overall economy.

The Nasdaq Composite is a market capitalization-weighted index of more than 3,700 stocks listed on the Nasdaq stock exchange. As a broad index heavily weighted toward the important technology sector, the Nasdaq Composite Index has become a staple of financial markets reports.

The Bloomberg US Government/Credit Bond Index is a broad-based flagship benchmark that measures the non-securitized component of the US Aggregate Index. The index includes Treasuries and agencies that represent the government portion of the index, and it includes publicly issued US corporate and foreign debentures and secured notes that meet specified maturity, liquidity and quality requirements to represent the credit interests.

The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

The ICE BofA US Convertible Index is an unmanaged index that measures performance of US dollar-denominated convertible securities not currently in bankruptcy with a total market value greater than $50 million at issuance.

Past performance does not guarantee future results.  An investment cannot be made directly into an index.

***Before investing, investors should carefully read the prospectus and/or summary prospectus and carefully consider the investment objectives, risks, charges and expenses. For this and more complete information about the fund(s), investors should ask their advisors for a prospectus/summary prospectus or visit invesco.com/fund prospectus.***

The opinions referenced above are those of the authors as of July 27, 2022. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.