



Convertible Securities Play Multiple Roles in Portfolios and Closed-End Funds

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Chuck Jaffe, in The NAVigator podcast, interviewed Tony Huang, associate portfolio manager for the Advent Convertible and Income Fund. Read the Q & A below as Chuck discusses with Tony the compelling reasons to add convertible securities, a hybrid security that can act like either a stock or a bond, to a stock portfolio. Huang talks about how different fund managers and



Tony Huang

individuals evaluate and purchase convertibles, whether convertibles are an asset class unto themselves, and more. .

The podcast can be found on AICA's website by clicking here: <https://aicalliance.org/alliance-content/pod-cast/>

CHUCK JAFFE: Tony Huang, associate portfolio manager for the Advent Convertible and Income Fund is here to talk convertible securities and what they can do for your portfolio in The NAVigator. Welcome to The NAVigator, this is where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, which is a unique industry organization in that it represents all facets of the closed-end fund industry, from users and investors to fund sponsors and creators. Today we're talking with somebody who runs a pretty unique closed-end fund. Tony Huang is associate portfolio manager for the Advent Convertible and Income Fund, that's ticker symbol AVK. The Convertible and Income Fund is a sixteen year old closed-end fund that tries to provide total return through a mix of current income and capital appreciation. Convertible securities are a big part of that strategy,

as the fund has to invest at least thirty percent of its assets in convertibles. At the end of last year, the fund had a lot more in convertibles. If you want to learn more about the fund, you're going to go to GuggenheimInvestments.com/AVK. Why Guggenheim? Because Guggenheim Investments is the servicing agent for Advent. Advent however is on Twitter @AdventCapital_. Tony Huang, good to chat with you.

TONY HUANG: Chuck, it's great to be here.

CHUCK JAFFE: Let's start with a quick primer on convertible securities. They are an asset class that I love personally -- I've owned them myself and encouraged my dad to own them back in the day -- that most people don't understand, and really don't understand why they want this kind of hybrid investment when they otherwise are controlling, "I buy stocks here and I buy bonds there."

TONY HUANG: Yeah, that's very understandable Chuck. I understand that investors may not know a whole lot about convertible securities at the beginning, but the attraction is that people believe that you receive access to a security that's part bond and part equity. But what's really important and the unique attribute of the convertible bond, is that you, the investor, have the ability to choose between the two. If the stock does great, you can convert your bond into stock at the end of the period. If the stock doesn't work very well, then you default back to a bond and you get the principal value of the bond back. Because you can have the better of the two, the long-term performance of the convertible asset class has actually been in the last thirty, forty years, closer to that of the equity indices than the bond indices.

CHUCK JAFFE: And yet, there are not a tremendous amount of convertible funds, especially in the ETF structure. Even in the closed-end structure, there are not a lot of convertible securities funds. Is that because there's a supply issue when it comes to convertibles, they're not that big? Is it because they trade differently when you're looking at how you're going to buy them? Why haven't we seen more of this, because they're such a good tool for those folks who understand them?

TONY HUANG: They do trade differently with different desks among the brokerages, but I think really a lot of it is the expertise needed to trade them. You've got a bond element, you have an equity element, but you also have to evaluate the option involved between the two. So traders, and portfolio managers, and other players in the convertible markets are bit in their own little world in regards to that, and as a result there aren't that many managers who

specialize in convertible securities. Advent is proud to be one of them. We're one of the larger players in the convertible asset class, but it is a very healthy asset class. It has about four hundred and fifty billion dollars of issuance around the world, over half of which is in the United States. A lot of growth companies, a lot of technology, healthcare, consumer discretionary companies use the convertible asset class to raise capital when they need it.

CHUCK JAFFE: Some of the folks who invest in convertibles will say, "I only want to invest in the really big ones, the brand names." There does seem to be a difference, at least in terms of popularity, between the big convertibles and the small ones. Does that create an opportunity? Why is there that discrepancy? Because if you're an ordinary stock investor, you're going to own large caps, you're going to own small caps. But it seems in convertibles, as I look at convertible funds, a lot of the funds that are out there kind of say, "Hey, we focus in a particularly small pool in the convertible space."

TONY HUANG: Well, you're right about that, Chuck, in that some funds focus on the more liquid aspects of the convertible asset class. For example, the only large ETF in convertibles limits itself to issuances that are, I think, four hundred or five hundred million dollars of issuance size. But active managers of convertible funds can take advantage of greater pricing inefficiencies among mid and small cap issues. We here at Advent, we have a full investment staff of seven analysts who are sector focused and geographically focused. We do take a look at all manner of convertible issuances. Some are done by small cap companies that are issuing bonds that are about a hundred million in size, and we have the trading expertise to navigate our way through those markets. We think that's a great way for active investments, the active investing attitude, to really add value in this particular asset class.

CHUCK JAFFE: Are people also getting value right now looking at convertibles in a closed-end fund structure because as I looked at AVK, the Advent Convertible and Income Fund, it's trading at a pretty significant discount? And the convertible space, the convertible securities funds that I've looked at, anything in closed-end funds that seems to own convertibles has been pretty heavily discounted for several years now.

TONY HUANG: Yes, I think that the convertible securities universe is one where investors do have to learn a little bit about the attributes of the product. The more they learn though, the more they like it. Because they like the idea that they have an option at their choice, to own an equity if it turns out well or a bond if the equity does not turn out well. I think the

real positives of the closed-end fund structure are that you get monthly income done on a very smooth basis. Convertible closed-end funds, of course, part of your appreciation comes from your income, part of your appreciation comes from capital gains. The capital gain part can be unpredictable. It may be short-term or long-term. It depends on when the fund decides to realize those gains. The convertible closed-end fund format allows the smoothing of those capital gains on a monthly basis. That helps, I think, create a more predictable set of income for the investor.

CHUCK JAFFE: There's also the way that convertibles trade. From an individual investor standpoint, this is one of those cases where just as most individuals shouldn't own traditional bonds too much or start to do more, most individuals are not going to get particularly involved in convertibles. But if they're looking, convertibles, there's always this option value. The, "Hey, what's going to be the best way to do this? Do I want to own this as a stock? Do I want to convert it to the bond?" When people think about convertibles, whether they wanted to do this themselves or they wanted to do it with a fund, is the basic thing, "Hey, you're looking for the ones that if it's got the best option value, that's the best deal"? Or is it not that simple?

TONY HUANG: A lot of the value comes from owning the convertibles, Chuck, that do have the most option value. There are convertibles of all kinds, right? There are convertibles where the strike price is far away and it mostly acts like a bond. There are convertibles where the stock has already done well and the strike price is close, or the stock price is past the strike price and so the convertible acts more like an equity. The ones who are in the middle, whether it's the most uncertainty, or whether over time the stock price is close to the strike price and therefore we don't know if the stock will go up or down, the outcome is still unknown. That is where the option value is the highest, and the fact that you have that choice in the end really values the most. That's another part of active investing in the convertible universe. The ETF that I spoke of that focuses on the liquid areas, it also doesn't differentiate. It owns all kinds of convertible bonds of all stripes. Active investing that is done by AVK, that is done by a lot of other convertible closed-end funds, focuses on convertibles that are close to the money where the stock price is close to the strike price. You are neither way out of the money or way in the money, and that allows you to isolate the fact that that option value becomes very meaningful down the line.

CHUCK JAFFE: But does that treat convertibles like a separate asset class? Or do you consider convertibles part of the asset class of the underlying asset? In other words, because you can own different things, I can have convertibles on a tech company, I can have convertibles on a bank. Do I wind up thinking of convertibles as an asset class? Or should I be thinking of, "No, it's a tech investment and a financial services investment?"

TONY HUANG: We think of convertibles as their own asset class, or as an add-on to a fixed income asset class where people are looking for duration protection, or as an add-on to an equity portfolio where people are looking for a little bit more protection. So the volatility aspect of the option, where the higher volatility is the more valuable than the option value is. If you remember your Black-Schole's theory, that's a very key part of owning that. When volatility goes up, which commonly happens when equity markets are weaker, that can cushion the blow. The decline that occurs in a convertible price because of the equity declines, and so that ends up cushioning your downside and adding to your downside protection. Which is a very good attribute which helps the Sharpe ratios of the convertible asset class. It's one reason why pensions like to invest in convertible funds too, because it provides them a little bit more certainty of their returns.

CHUCK JAFFE: Yeah, it's kind of a self-hedging investment in its own way.

TONY HUANG: I think that's a good way of putting it, Chuck. Yes.

CHUCK JAFFE: Well, then we'll end there. This has been great. Learned a lot and know a lot more in terms of how you might want to handle convertibles in a portfolio. Tony Huang, thanks so much for joining me.

TONY HUANG: Chuck, it's been great to be here. Thank you.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe, and you can learn more about my work and my show at MoneyLifeShow.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook, LinkedIn, and Twitter @AICAlliance. Thanks to my guest, Tony Huang, associate portfolio manager at Advent Convertible and Income Fund, ticker AVK. Follow Advent on Twitter @AdventCapital_ and learn more online at GuggenheimInvestments.com/AVK. The NAVigator podcast is available every Friday,

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