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LUPUS ALPHA CONVERTIBLES REPORT 04/2017

Growth in a fixed income wrapper

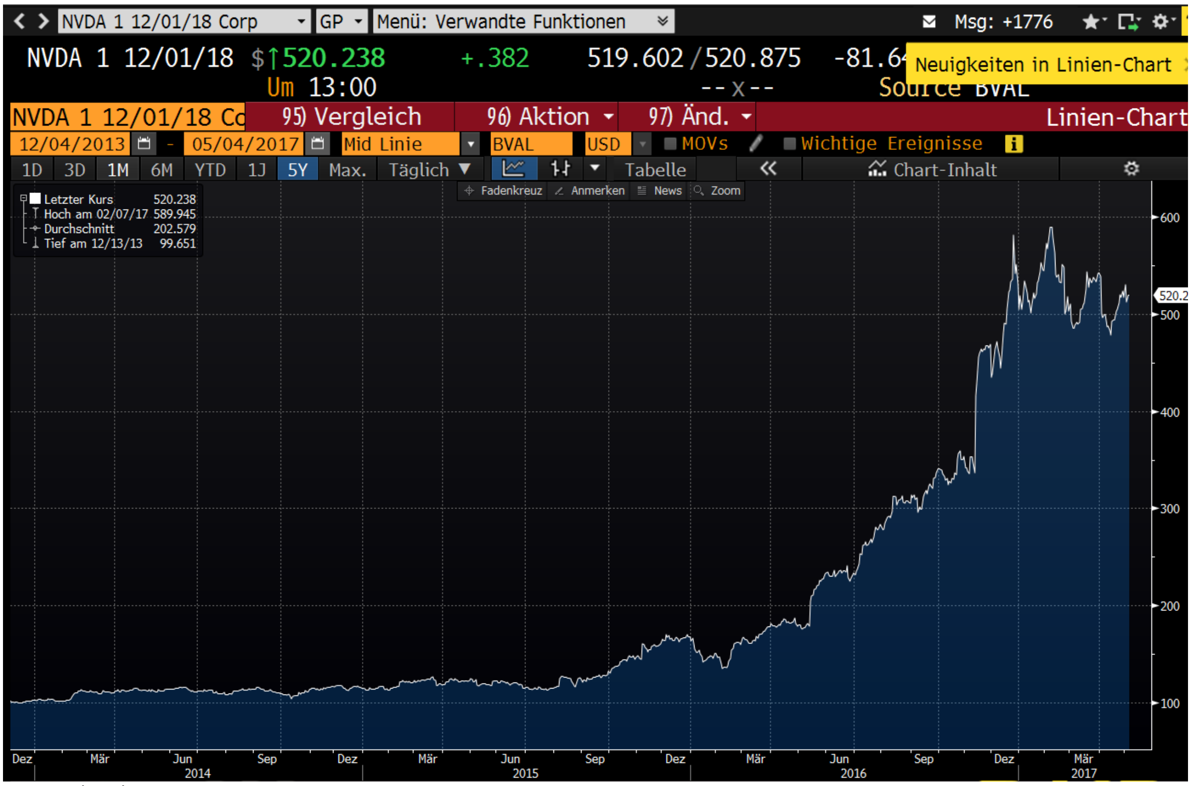
When it comes to growth stocks, few or no investors think of convertibles. This is a wrong perception, since the first convertible was issued in 1843 precisely for this reason: to finance an ambitious growth company, the New York and Erie Railroad Company. A growth tilt that is still in the market today: Many innovative, rapidly growing companies are issuers of convertibles. These are often growth stocks, far away from the blue-chip driven (Equity-) indices. Convertible Bonds have the legal wrapper of a fixed-income instrument with a legal right of repayment and coupon in the prospectus. So it is an attractive opportunity also for-fixed income investors to think about investing in convertibles given the greater growth momentum and performance of small and medium-sized companies.

Investors are faced with a dilemma. Both bond and equity prices have already gone up a long way. It is not easy to find interesting investment opportunities. Even traditional bonds are affected by very low coupons, narrow spreads and high prices. In case of rising interest rates investors face significant losses in value.

The hybrid asset class of convertibles represents an alternative. Convertible bonds offer the possibility of a buffered investment **with which fixed income investors can also profit from growth on the equity side**. The special attraction lies in the fact that fast-growing small and mid caps frequently issue convertibles to finance their dynamic corporate growth.

This growth tilt means for investors that the price potential of convertibles is virtually unlimited based on their integrated conversion right. Convertibles can be converted into common stock at a predefined conversion ratio within a certain period. If the price of the underlying stock rises, the value of the conversion right also increases. An example of the potential for convertibles is **Nvidia Corporation**, one of the biggest developers of graphic processors and chipsets for personal computers and game consoles. In 2014 the convertible was issued at a price of 100 and traded up to a price above 500 (see Chart 1).

Chart 1: Nvidia's convertible benefits from strong underlying equity performance

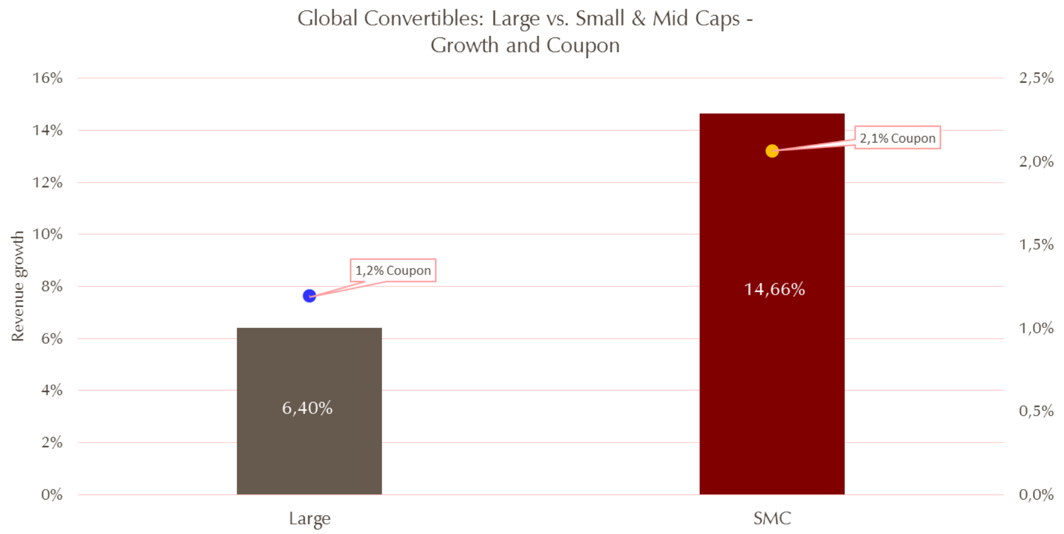


Source: Bloomberg

Especially growth-oriented companies including a wide range of small and mid caps issue convertible bonds. These companies seeking a cheaper way to raise capital than corporate bonds. **Raising capital via convertibles provides issuers with a number of advantages.** An important advantage is that small and medium-sized companies have to pay less interest ~~rates~~ for convertibles due to their conversion option compared to straight corporate bonds. In addition, small firms increase their shareholder base if convertibles will be converted into equities. From the company's point of view expensive debt can thus be converted into cheap equity capital. Raising capital via convertibles is also much easier than a capital increase or issuing corporate bonds – neither a credit rating nor a long roadshow are absolutely necessary.

From the investor's point of view, **investments in hidden champions offer a huge potential: higher revenue and earnings growth compared with large caps along with comparatively higher coupons** (see Chart 2). Moreover, investors can achieve regular income with convertibles due to their coupon keeping in mind that growth companies otherwise only pay dividends in exceptional cases. Serious arguments indeed for investing in convertible bonds.

Chart 2: Global convertibles: Much higher revenue growth and higher coupon of small and mid caps compared to large caps

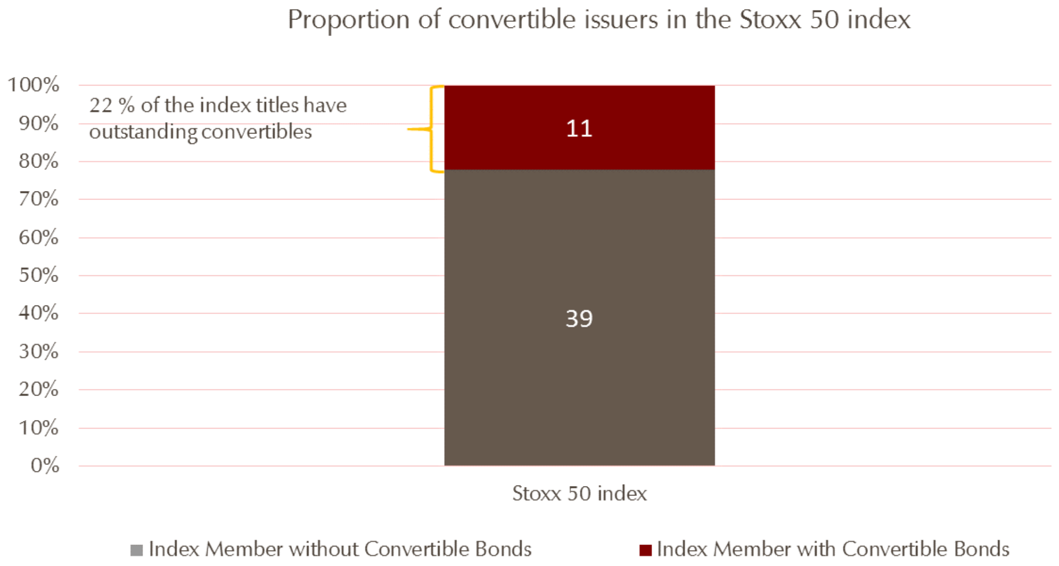


Sources: Lupus alpha, Bloomberg, DB Convertibles; as at: 20 April 2017; data: weighted three-year average

Growth companies' convertibles also offer valuable **diversification opportunities** for traditional bond investors. Straight corporate bonds are rarely found in the small and mid cap sector. Usually, an investment in equities plays a marginal role for bond investors under risk aspects.

An additional diversification effect arises from the fact that small and mid caps are not included in the classic blue chip indices. So their performance is hardly affected at all by index investors' buying and selling decisions via futures or ETFs. For example, **only every fifth company in the Stoxx 50 index comes to the market with a convertible bond** (see Chart 3).

Chart 3: Proportion of convertible issuers in the Stoxx 50 index



Sources: Lupus alpha, Bloomberg, DB Convertibles; as at: 20 April 2017

These circumstances show that the performance of convertibles depends largely on the individual business development of the underlying stock. **For investors, there is the opportunity to generate additional alpha via a fundamental analysis of individual stocks in the convertible universe.** Small and mid caps usually have a shorter corporate history and are much less analysed than blue chips. As a result, intensive research, company visits as well as meetings with the management can provide important information for investment decisions.

Furthermore, growth companies are usually potential takeover candidates that hold particular upside potential. For convertible bond investors, protection clauses in the prospectus ensure that they are not disadvantaged in case of a takeover or merger, they can actually even outperform straight equities in these scenarios.

All in all, convertibles provide the upside potential of equities while the downside risk is limited: **Growth with an airbag.** Both the bond's coupon and its redemption on maturity effect an asymmetrical risk structure. It means in effect: in rising equity markets the participation is the dominant element, in falling markets the bond component helps to mitigate potential losses.

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