CONVERTIBLE SECURITIES

ADVENT CAPITAL MANAGEMENT, LLC

TRUMP ERA: WHY INVESTING IN CONVERTIBLES MAKES SENSE

Convertibles have historically performed well in a rising interest rate environment.

TRUMP ECONOMICS

The Republican sweep of both the White House and Congress creates the opportunity for President-elect Donald Trump to implement the majority of his economic policies. To put this into perspective, a study by Moody's Investors Service estimated that should Trump's policy initiatives be fully implemented, such as tax cuts, capital repatriation, higher defense spending, protectionist tariffs, the mass deportation of undocumented immigrant workers, and no change to entitlement spending, the U.S. budget deficit would increase by approximately 7 trillion dollars, pushing the federal debt/GDP ratio from its current 74% to 100% by 2020.[1] It is anticipated that these policies could lead to an increase in GDP growth, more inflation, higher interest rates, a steeper yield curve, an extension of the business cycle, tighter credit spreads, lower default rates, a stronger U.S. dollar, and greater volatility in the equity market. We are considering the outcomes of Trump's policies, but more specifically, we are evaluating how the new Trump administration could impact convertible investors.

POTENTIAL MARKET OUTCOME	FAVORABLE IMPACT ON THE CONVERTIBLE MARKET
Higher Interest Rates	Convertibles have historically performed better than many other fixed income investments during periods of rising interest rates, with new issuance increasing during these periods.
Greater Economic Growth	Convertible underlying equities reported significantly higher EBITDA and sales growth versus the broader equity indices[2].
Extension of Business Cycle	Lower default rates and tighter credit spreads may benefit sub-investment grade convertible issuers.
Capital Repatriation	Convertible investors could benefit from dividend protection and takeover ratchet features (anti-dilution provisions) as capital is returned to shareholders and merger and acquisition activity accelerates.
Increased Volatility	The convertible's embedded equity option may become more valuable when equities rise.

HIGHER INTEREST RATES

Trump's economic policies are likely to boost inflation, and thus interest rates, due to the combined effect of deficit spending and his trade and immigration initiatives which may increase wages at a time of low unemployment. Convertibles are suited to perform well in this environment because of their relatively low interest rate risk compared to other fixed income investments. In fact, convertibles have an average life of about four years and a duration risk (rho risk) of about two years[3], or about half that of an equivalent straight bond. When interest rates rise, although the market value of the convertible's bond component falls, the value of **the convertible is helped** somewhat by the embedded option component, which has historically benefited from higher rates when all else is equal. When interest rate increases are precipitated by a strengthening economy, convertibles tend to perform well as equity markets

[1]Robis, R. (Ed.). (November 2016). Is the Trump Bump To Bond Yields Sustainable? BCA Research.pg. 5.
[2]Barclays (November 29, 2016). U.S Convertibles Outlook 2017 Ready for Takeoff, pages 28-29.
[3]Duration risk/rho risk is the sensitivity of the convertible bond to interest rates which takes into consideration both the "duration" of the bond and the offsetting interest rate sensitivity (rho) of the warrant. Duration/rho risk of two years means that if interest rates were to rise (fall) 1%, the convertible price would increase (decrease) by approximately 2%

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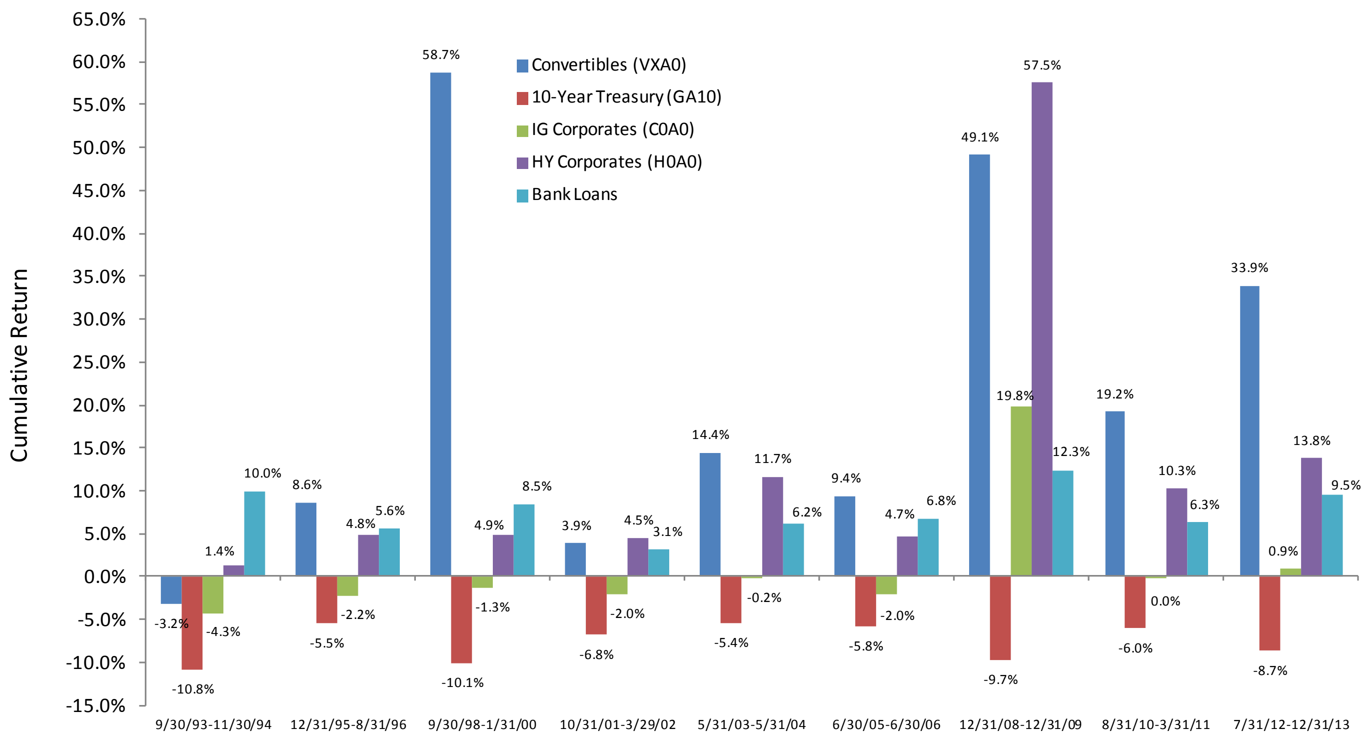
rise, as illustrated in Figure 1.

Global convertible new issuance also typically increases when interest rates rise, as convertibles, which tend to have lower coupons, become increasingly a more attractive financing option when compared to straight fixed income alternatives.

FIGURE 1: IN PERIODS OF RISING INTEREST RATES Convertibles Have Outperformed MANY OTHER FIXED INCOME INVESTMENTS[4]



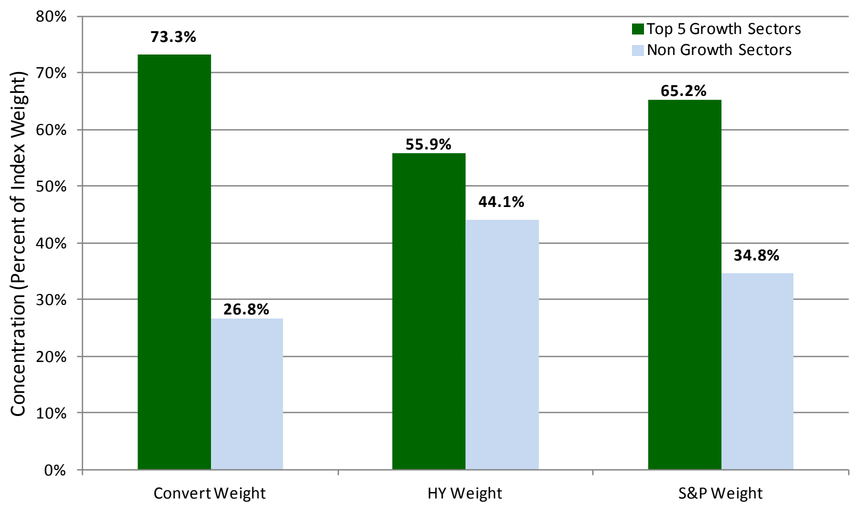
Rise in 10-Year Treasury Yield	**252 bps**	**137bps**	**225 bps**	**116 bps**	**128 bps**	**122 bps**	**163 bps**	**100 bps**	**156 bps**

GREATER ECONOMIC GROWTH

Although Trump's policies may lead to greater economic growth, and by extension higher earnings and stock prices, this could be offset by a rise in interest rates and a stronger U.S. dollar. Under such conditions, stocks with higher growth rates, which may allow them to protect margins even in an inflationary environment, could outperform. As shown in Figure 2, growth stocks dominate issuers in the convertible market because growth companies are frequently in need of capital. Convertible securities serve as an ideal financing tool for these issuers because as the share price rises, the convertible, which was previously sold at a premium to the existing share price, can be exchanged for stock, thereby strengthening the company's now enlarged balance sheet.

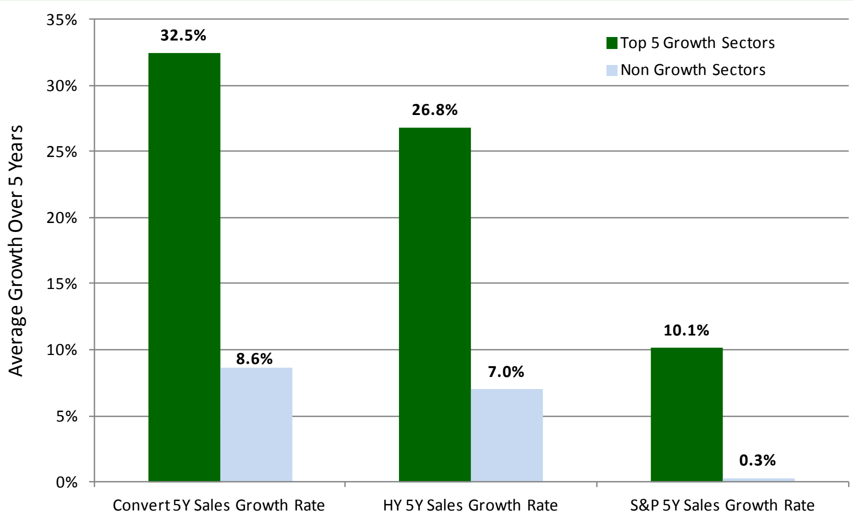
[4]Sources: Bank of America Merrill Lynch Convertible Research; www.federalreserve.gov; Bloomberg, Credit Suisse. VXA0 is the Bank of America Merrill Lynch All U.S. Convertibles Index. GA10 is the Bank of America Merrill Lynch Current 10-Year U.S. Treasury Index. C0A0 is the Bank of America Merrill Lynch Corporate Master Index. H0A0 is the Bank of America Merrill Lynch High Yield Master II Index. Bank loan performance is represented by the Credit Suisse Institutional Leveraged Loan Index (CSILLI). Information is shown for the periods since the inception of CSILLI on January 1, 1992. Periods of rising interest rates are defined as an increase in the 10-year Treasury Yield of 100 basis points (bps) or more. A move of 100 basis points equals 1%.

Figure 2: Growth Sector Concentration is Greater in Convertibles Versus High Yield and Large Cap Equity[5]



While the convertible market has significant exposure to growth companies, it is noteworthy that the convertible issuers' growth rate is typically faster than the growth rates of issuers in other indices, as illustrated in Figure 3. If Trump's policies result in a steeper yield curve, capital repatriation, and less government regulation the financials, technology, and healthcare sectors could benefit, respectively; all of which are included in the Top 5 Growth Sectors.

Figure 3: Convertible Issuers Have A Higher Five Year Sales Growth Rate Versus High Yield and Large Cap Equity[6]



[5] Top 5 Average Growth Rate Sectors are determined by identifying the top 5 average sales growth sectors for companies included in the VXA0, the S&P 500, and all public companies in the H0A0 Indices. The Top 5 Growth Sectors include the following: Information Technology, Healthcare, Financials, Consumer Discretionary and Telecommunications. Non Growth sectors include the remaining GICS sectors. Data is as of 9/30/2016, using the VXA0 Bank of America Merrill Lynch All U.S. Convertibles Index for the Convert Weight and the H0A0 Bank of America Merrill Lynch High Yield Master II Index for the HY Weight. S&P is the S&P 500 Index. Source: Bloomberg

[6] Five Year Sales Growth Rate is calculated as the sum of most recent five year revenue growth year over year divided by 5. Data is as of 9/30/2016, using the VXA0 Bank of America Merrill Lynch All U.S. Convertibles Index for the Convertible 5Y Sales Growth Rate and the H0A0 Bank of America Merrill Lynch High Yield Master II Index for the HY 5Y Sales Growth Rate. S&P is the S&P 500 Index. The Top 5 Growth Sectors include the following: Healthcare , Telecommunications, Consumer Discretionary, Information Technology, and Financials. Non Growth sectors include the remaining GICS sectors. Source: Bloomberg

Extension of Business Cycle

Trump's economic policies, if they are successful in increasing nominal economic growth into the 4-6% range, could extend the expected life of this credit cycle by several years. The excess return of corporate debt over Treasuries tends to be higher during periods when nominal GDP growth, currently 2.8%, is expanding as default rates fall and credit spreads tighten. This market environment is advantageous for the convertible asset class as the fixed income component of convertibles may benefit from stable-to-improving credit spreads.

Capital Repatriation

Capital Economics estimates that U.S. companies are hoarding 2.5 trillion USD overseas, or about 14% of GDP[7]. Should a Trump tax policy encourage some of these funds to return home, it is likely that a portion would be used for merger and acquisition activity or to return cash to shareholders in the form of stock buybacks and dividend increases. There are two ways in which convertible investors could benefit. First, since there is a significant number of convertible issuers with market capitalizations under 10 billion USD, they often make attractive targets for larger suitors. In fact, year-to-date, there have been 21 such transactions including Oracle's purchase of NetSuite, Qualcomm's acquisition of NXP Semiconductors, and Medtronic's takeover of HeartWare. Second, over the last ten years, convertible securities have undergone a significant positive structural transformation whereby investors typically receive more shares in the convertible when a company raises its dividend or is acquired, which has allowed convertible investors to better enjoy the fruits of a takeover premium alongside equity investors.

Increased Volatility

Trump's policy initiatives, both domestic and foreign, are only likely to exacerbate the possibility of increased equity market volatility already provoked by differing central bank monetary policies, forthcoming political contests in Europe, commodity price fluctuations, and concerns in emerging markets. As an asset class, convertible securities could be beneficiaries of rising volatility as the **embedded equity component may become more valuable as equities rise**, all else being equal. Because convertible securities become more bond-like (defensive) when equities fall, but more equity-like when they rise, convertibles demonstrate positive asymmetry, or structural alpha, that is difficult to replicate.

Closed- End Funds, Convertibles Are A Special Case

Recently, the investment environment has been challenging for closed-end funds, which have been trading down in-line with most fixed income instruments. However, the recent downturn has provided investors with the opportunity to exploit an impending interest rate hike through an increased allocation to convertible closed-end funds. Convertibles are less susceptible to interest rate increases given their lower duration compared to other bond asset classes.

The market could distinguish between closed-end funds that invest solely in treasuries, investment grade corporates, preferred stocks, and municipals as opposed to closed-end funds that invest in convertibles, which

[7]Hunter, Andrew. (September 19, 2016). US Economic Update. Capital Economics.

have an equity option that may benefit from a rising interest rate environment as a result of a stable-to-improving economy. Convertibles are one of the few fixed income investments that have historically performed well in the aforementioned investment climate.

Conclusion

Although often overlooked, convertibles are a separate asset class that has a long track record of delivering returns only slightly below equity indices with less risk over the long term.[8] Consequently, convertibles may add value when included in either a bond or stock portfolio. As the Trump Era unfolds, convertibles may offer a unique solution for improving the diversification and positive asymmetry of a portfolio.

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[8]From December 31, 1987 (inception of the VXA0 Index) through December 31, 2016, the BAML All US Convertibles Index (VXA0) returned +9.25% (annualized) with a standard deviation of 11.64%. For the same period, the S&P 500 returned 9.83% (annualized) with a standard deviation of 14.25%; and the Russell 2000 returned 9.91% (annualized) with a standard deviation of 18.60%. Source: Bloomberg