Convertible Bonds as an "Equity Replacement Strategy"

Wellesley Asset Management
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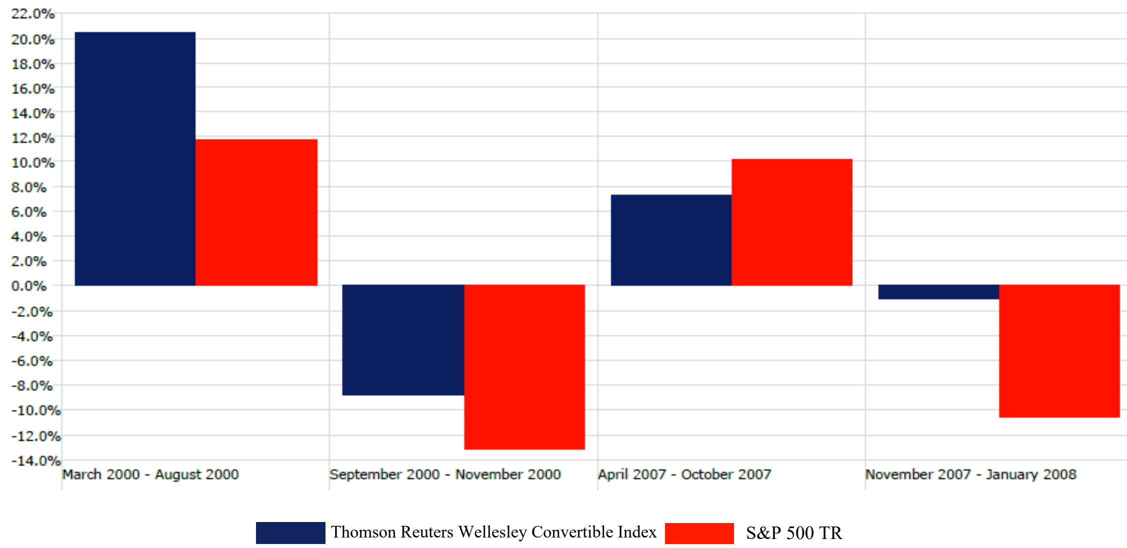
The near decade-old bull market finally showed cracks in 2018, as the S&P 500 returned -4.38%, at one-point falling over 24% from its all-time high. Volatility also returned in a meaningful way, as the VIX, a measure of market volatility, surged over 112% for the year, signaling a potential end to the muted volatility that has accompanied rising asset prices over the past 10 years.

Given this back-drop, more investors now view the stock market in late cycle and fraught with risks. Moving forward, we hold the view that convertible bonds may be utilized as an "equity replacement strategy" for strategic investors not interested in attempting to time the market top. Convertible bonds allow investors to remain long the market with the added benefit of reduced equity exposure and a degree of downside protection.

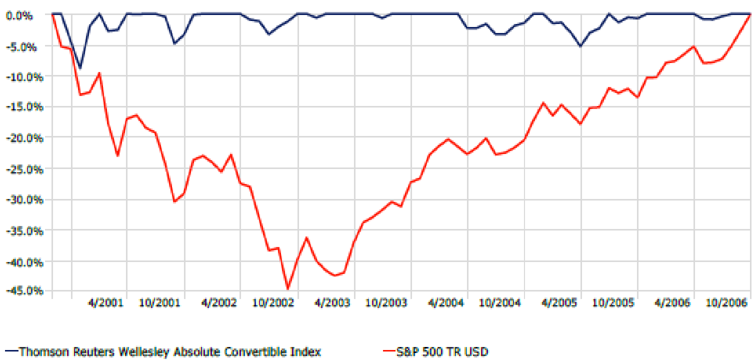
In the last two bull-to-bear market rollovers (March 2000 and October 2007), convertible bonds captured more equity upside during the final months of the bull market than they did at the beginning of the subsequent bear market.

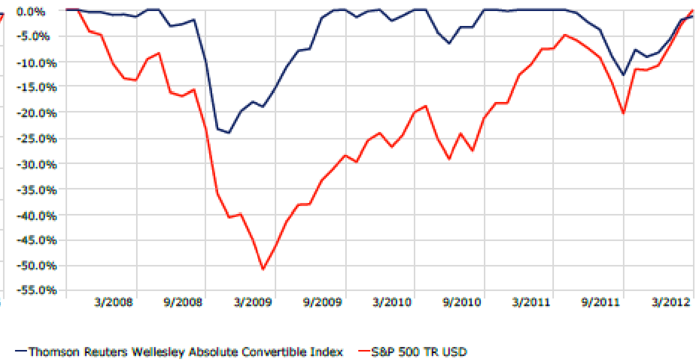


For the 6-month period prior to the beginning of the 2000-2002 Bear Market, the Thomson Reuters Wellesley Absolute Convertible Index ("TRW") captured a whopping 173.8% of the S&P 500's upside, returning 20.39% compared to 11.73% for the S&P 500. In the 3-month period that followed the start of the 2000-2002 bear market, the TRW Index captured 57.53% of the S&P 500's decline of -13.12%, returning -8.70%.

For the 6-month period prior to the beginning of the Financial Crisis of 2007-2009, the TRW Index captured 71.65% of the S&P 500's upside, returning 7.28% compared to 10.16%. More notably, the TRW Index declined just -1.02% during the 3-month period that followed the start of the 2007-2009 Bear Market. The TRW Index captured only 9.67% of the S&P 500's decline of -10.55%.

In addition, convertible bonds also found their lowest price point faster than equities, and rebounded much sooner to pre-bear market values.





During the 2000-2002 Bear Market, the TRW Index experienced a drawdown of only -8.86%, compared to -44.73% for the S&P 500. The TRW Index's peak decline occurred in November, 2000, and recovered to its pre-bear market value by the end of January, 2001. The S&P 500's peak decline occurred in September 2002, and did not recover until October, 2006.

During the Financial Crisis of 2007-2009, the TRW Index's drawdown was just -24.19% compared to -50.95% for the S&P 500. More importantly, the TRW Index's peak decline occurred in November, 2008, and had recovered to pre-bear market NAV by the end of September, 2009. By contrast, the S&P 500 bottomed out in February, 2009, and did not recoup its value until March, 2012.

Wellesley Asset Management

Wellesley Asset Management has managed convertible bond strategies since its founding in 1991, and employs a disciplined approach that strives for downside protection and risk-adjusted returns. Our portfolios accomplish this by holding bonds with short to mid-term maturities and priced at or near par value to avoid increased equity sensitivity.

During bull markets, positive returns of the underlying equity drive convertible bond prices higher. In a market pullback or correction, the price of convertible bonds can rise as they draw closer to maturity. In other words, shorter-term convertible paper can potentially recover value without the tailwind of rising stocks.

Conclusion

Investors remain uncertain if the top of the current bull market has already taken place, and if it hasn't, when a sustained market downturn might occur. Wellesley Asset Management's convertible bond strategy has historically offered an asymmetrical risk/return profile during the end of bull and start of bear markets due to the hybrid nature of convertible securities. Implementing an experienced, active convertible bond manager as an equity replacement at the portfolio level may potentially enhance investor outcomes and remove the difficulty in correctly timing the next bear-to-bull rollover.

Important Disclosures:

Past performance does not guarantee future results. *No content in this article should be construed as specific investment advice, or replacement for investment advice from Wellesley Asset Management, Inc. (Wellesley), or any other investment professional. All investments, including convertible bonds, have a risk of loss.*

Investments in convertible securities include risks associated with both fixed-income securities, including credit risk and interest risk, and common stocks. Convertible securities may be rated below investment grade. Exchangeable and synthetic convertible securities may be more volatile and less liquid than traditional convertible securities. In general, stock and other equity security values fluctuate, and sometimes widely fluctuate, in response to activities specific to the company as well as general market, economic and political conditions. Lower rated fixed-income securities are subject to greater risk of loss of income and principal than higher-rated securities. The prices of lower rated bonds are likely to be more sensitive to adverse economic changes or individual corporate developments. When the general level of interest rates goes up, the prices of most fixed-income securities go down. When the general level of interest rates goes down, the prices of most fixed income securities go up.

Index Descriptions:

Index	Description	Source
Thomson Reuters Wellesley	Thomson Reuters Wellesley Absolute Convertible Bond index ("TRW"). The Index is a joint venture between Thomson Reuters and Wellesley Asset Management that was created in January 2013. Index performance from inception date of January 1, 2000 to February 2002 is hypothetical performance based upon historical trading of convertible bonds in all WAM client accounts. Index performance for the period from February 2002 to the creation date of January 1, 2013 is calculated based upon a model portfolio maintained by WAM. TRW is intended to represent a strategy with the goals of absolute returns and outperforming both equities and fixed income over complete market cycles deploying convertible bonds. WAM has discretion over the selection of index constituents and their weighting in the index. **Note on TRW index performance from inception of January 1, 2000 to February 1, 2002 only:** Hypothetical performance during this period is based on actual trading of convertible securities only in client accounts. Securities other than convertible bonds are excluded from the index performance calculation in this period. There are inherent limitations on hypothetical performance that may not reflect the impact that material economic and market factors might have on the advisor's decision-making if the advisor was managing convertible bonds only in this period.	Thomson Reuters
Standard & Poor's 500 Total Return	A free-float capitalization-weighted index based on the common stock prices of 500 top publicly traded American companies, as determined by S&P and considered by many to be the best representation of the market.	Bloomberg data / Standard & Poor's
VIX – CBOE Volatility Index	A volatility index that measures the market's expectation of 30-day volatility	Chicago Board Options Exchange

Drawdown is the peak-to-trough decline during a specific record period of an investment, fund or commodity. A drawdown is usually quoted as the percentage between the peak and the trough.

Upside capture is a statistical measure of an investment manager's overall performance in up-markets. The up-market capture ratio is used to evaluate how well or poorly an investment manager performed relative to an index during periods when that index has risen.

Downside capture is a statistical measure of an investment manager's overall performance in down-markets. The down-market capture ratio is used to evaluate how well an investment manager performed relative to an index during periods when that index has dropped.

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