Wellesley Asset Management

Convertible Bond Specialists

Wellesley Asset Management Commentary | October 2019

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Third Quarter Total Return Comparison (%, through 09/30/2019):

	Q3 2019	YTD	1 Year	3 Years*	5 Years*	10 Years*	Since Inception 12/27/2007*
Miller Convertible Bond Fund I (MCIFX)	-0.17	10.04	2.04	3.92	4.11	6.76	6.11
TRW	-0.03	10.91	2.78	4.94	5.21	7.52	6.98
Bloomberg Barclays U.S. Aggregate Bond	2.27	8.52	10.30	2.92	3.38	3.75	4.19
S&P 500 TR	1.70	20.55	4.25	13.39	10.84	13.24	8.43
Russell 2000	-2.40	14.18	-8.89	8.23	8.19	11.19	7.42

The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost.

Please review the Fund's prospectus for more information regarding the Fund's fees and expenses including other share classes. For performance information current to the most recent month-end, please call toll-free 877-441-4434.

Total operating expenses for the Miller Convertible Bond Fund are Class A 1.45%, Class C 1.95% and Class I .95%.
See index descriptions and accompanying footnotes.
**Returns are annualized.*

3rd Quarter Update – "History doesn't repeat itself, but it often rhymes" – Mark Twain

Our colleague, Dennis Scarpa CFA, recently wrote about the economic parallels between 2007 and today in the paragraph below:

> In the face of what seems to be a stock market that can only go up, we may have begun to see some cracks in the proverbial armor. September was a busy month for investors, from the Federal Reserve cutting interest rates to rising trade tensions with China. While 2019 is very different from 2007, here at Wellesley Asset Management, we see some eerily similar parallels that have us stopping to take a hard look at the market. Let us dive deeper. Since last year, U.S. GDP growth has been slowing. Jerome Powell, the Chair of the Federal Reserve, has been signaling weaker future growth forecasts with no risk of a recession and also signaling continued strength within the economy. Warning signs, such as the inverted yield curve, which is widely accepted as a predictor of future recessions, have been ignored by most investors, while stock market indices set new highs in July. August took a quick turn and the market rallied on the Fed rate cuts on September 18th. Does this look familiar? If so, you may be thinking this is simply a review of the past few months and you would be correct. But it is also an accurate depiction of the economic conditions 12 year earlier. Consider that in 2007 before the Great Recession, the yield curve inverted over that summer, U.S. growth had begun to slow, the stock market made record highs in July 2007, sold off in August and the Fed cut rates on September 18th (even the same day!).

Everyone remembers the events that happened next which led to the Great Recession. Similar to the end stages of the bull market in 2007, the financial markets are going through a period of heightened volatility. The news seems to toggle between good and bad while investors move from "risk on" to "risk off" mode. It is easy to see why market participants are having a hard time deciding how to position as there are potential positive and negative catalysts in the markets. On the positive side, the Fed is still lowering rates and the economy continues to be strong. An end to the trade war could be a potential catalyst to send stocks higher. On the negative side, global economic weakness could lead to a slowing U.S. economy. In addition, continued political uncertainty and/or a prolonged trade war could lead to a sell-off in U.S. stocks.

All of this uncertainty reminds us of why we love the optionality that convertible bonds provide to investors. We don't need to get caught up in the daily drama of the news cycle that often lead to market volatility. As long as we are investing in short duration, high quality convertible bonds, we believe our investors can enjoy the asymmetric returns that convertible bonds offer. If market news is positive and stocks trade higher, we should participate in some of the upside. Conversely, if we experience a downturn in stocks, we should be able to minimize downside risk for our investors. Convertible bonds may shield our investors from market volatility and provide a vehicle for us to pursue our goal of outperforming both stocks and bonds over full market cycles.

What's the big deal?

Third quarter convertible issuance surged to $22 billion, marking the highest level of any third quarter issuance since 2003. This puts year-to-date issuance at just over $46 billion, just behind issuance for the entire year of 2018, which represented the most convertible issuance since 2008. Convertible bonds tend to have shorter maturities than straight debt, so new issuance is important to offset bonds that are maturing, being called, or being put. In this commentary we will discuss the resurgence of convertible issuance and why we think it is sustainable.

Corporate CEOs issue convertible bonds for three reasons:

1) they want to issue debt at a lower coupon than they could if they were issuing straight debt
2) they want to issue stock at a premium to the current market
3) they want to monetize the volatility of their stock

Since 2008, interest rates have fallen significantly and credit spreads have narrowed. These factors have made it very inexpensive to issue straight debt at the cost of convertible issuance. In fact, the high yield and investment grade markets have grown two to three times in size since the Great Recession while the convertible market has remained the same size.

While interest rates continue to fall, credit spreads have been trending higher since 2018. Though issuing in the straight debt market is still attractive, we feel corporate CEOs are starting to consider the second and third reasons listed above, as they issue debt in the convertible bond market. With equities trading close to all-time highs, selling stock at a premium to the current market value is starting to look attractive. In addition, markets have become more volatile in recent months. One of the key components to determining a convertible bond's conversion premium* is the volatility of the underlying stock. As volatility increases, conversion premiums on new deals also increase.

The technology sector continues to dominate convertible issuance in 2019, accounting for over 30% of the capital raised. This shouldn't surprise anyone as technology stocks tend to be the most volatile stocks in the market. The biggest deal of the year came in September when Avago issued over $3.7 billion of a mandatory convertible preferred. This was the largest convertible deal since Alibaba issued a $5.5 billion mandatory back in 2016.

We remain bullish on new issuance in the convertible market for a few reasons. As previously mentioned, the straight debt markets have grown significantly over the last 10 years. As a result, the average deal size has also increased. Smaller companies wanting to raise less than $500 million have found it tough to gain traction in the straight debt markets. The convertible market has been receptive to smaller issuers and we think that trend will continue in the future. In addition, BBB credits now make up half of the investment grade market. When these companies refinance their debt, they may not find appealing terms in the straight debt markets as portfolio managers try to diversify and upgrade their credit risk. The convertible market could become an attractive financing alternative for these credits. Finally, we have mentioned before that half of the high yield market matures within the next three years. Similar to the BBB rated companies, some high yield issuers may find more favorable financing terms in the convertible market.

Market trends have been on the same glide path for over ten years now. But with the winds suddenly shifting, companies raising capital may find the convertible market more appealing than the straight debt markets. That's a big deal! If this happens, the larger investible universe should provide a potential benefit to convertible investors.

*Conversion premium = (convertible price – parity) / parity. Parity = conversion ratio x stock price.

Index Descriptions:		
Index	**Description**	**Source**
TRW	TRW is the Thomson Reuters Wellesley Absolute Convertible Bond Index. The Index is a joint venture between Thomson Reuters and Wellesley Asset Management ("WAM") that was created in January 2013. Index performance for the period from February 2002 to the creation date 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.	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
Bloomberg Barclays U.S. Aggregate Bond	A market capitalization-weighted index often used to represent investment grade bonds being traded in the United States. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds and a small amount of foreign bonds traded in the U.S.	Bloomberg data / Barclays
Russell 2000	Includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. The index measures the performance of the small-cap segment of the U.S. equity universe and is completely reconstituted annually to ensure larger stocks do not distort the performance and characteristics of the true small-cap opportunity set.	Russell

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

Investments in convertible securities subject the Fund to the risks associated with both fixed-income securities, including credit risk and interest risk, and common stocks. A portion of the Fund's 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. All fixed-income securities are subject to two types of risk: credit risk and interest rate risk. 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.

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