The Convertible Investor

An Informative Guide for Investors Who Seek Growth and Preservation of Wealth

Greg Miller CPA, Publisher and Michael Miller CFIP, Editor

SPRING 2020 EDITION

Wellesley Asset Management

Convertible Bond Specialists

Wellesley Asset Management, Inc.
20 William Street, Wellesley, MA 02481
781-416-4000 www.wam.com

IN THIS ISSUE …

Dennis Scarpa CFA, Senior Analyst contributed the articles for this newsletter

The Markets and Convertible Bonds: A Plan to Stay the Course

We are truly in the midst of unprecedented times. Like you, our lives have been upended in numerous ways. We recognize that many of our clients are concerned, not only about the markets, but also about their daily lives. While this is not something that can be fixed quickly, we are all adapting to changes such as social distancing and staying at home. Markets during this time have been changing as well. We've seen some of the largest swings over the past few weeks in U.S. history. Our advice to clients is something that we take in stride as well: Don't let the headlines drive your investment strategy. A solid strategy is based on your own financial situation, goals, and objectives. Within this article, we will review our outlook for the markets, specifically convertible bonds, along with a few points of comparison from prior downturns.

The question that we are asked frequently, particularly of late, is where do we go from here? We answer this by informing you of the facts and reviewing what we have seen in prior sell-offs. First off, convertible bond issuance over the past few years has been very strong.

(Continued on Page 2)

The year 2019 yielded the largest issuance since 2012, and 2018 was not far behind. This is important because many of these companies have left that capital untouched, and thus have cash on their balance sheets. While their stock prices may have fallen recently and could strain revenue for a period of time, their cash positions allow them to safely continue making their debt payments. These types of companies are exactly what we want to invest in – sturdy companies with solid balance sheets that are now trading at more reasonable prices. For some time, these convertible bonds have been trading at prices significantly out of our range. With the sell-off, this is creating a buying opportunity for us. Similar to prior periods such as 2018, we are now able to purchase these convertible bonds at a much more reasonable price. This may help to provide protection against additional market volatility in the future, along with the potential for further appreciation to the upside.

While this situation is different from anything that we have seen in the past, history can help put some of it in perspective. We've always focused on mitigating risk for clients. To give you a frame of reference, most recently our strategy has held up well versus the broader markets. Through the first two months of the year, the WIA Composite was down 0.6%, versus the S&P 500's decline of 8.3%. This has played out in a similar manner longer term. Since 2000, the S&P 500 has had 23 negative quarters and our strategy, as measured by the WIA Composite, has outperformed in 21 of them. This is the benefit of utilizing a strategy such as Wellesley Asset Management's convertible bond investment strategy.

To provide further detail, let us look at an example of another market sell-off. During the financial crisis of 2007-2009, the worst of the pain in the markets began with the Lehman Brothers' bankruptcy on September 15, 2008. That day the S&P 500 fell 4.7%. From there, the fallout spread quickly across the economy and the markets followed suit. That month, the S&P 500 closed down 8.9%, while the WIA Composite was in a similar position, falling 8.0% or capturing 90% of the downside. Over longer time frames, our goal is to provide a much higher degree of protection when markets fall. But over short time frames, as markets sell off quickly, panic selling can often ensue, creating a fall in the value of all assets, including convertible bonds.

The following months demonstrated a true sign of our conservative strategy. In October, the S&P 500 was down 16.8% and the WIA Composite fell 8.5% (51% downside protection). The next few months, the S&P 500 fell 7.2% in November, rose 1.1% in December, and then continued to fall 8.4% and 10% respectively in January and February 2009. **Over this period the WIA Composite only fell 0.66% in November (9% downside) and then rose 6.26%, 1.99%, and fell 0.01% the following months respectively, outperforming the S&P 500 collectively by 30.3%.** While we cannot predict the future, we view the behavior of convertible bonds today in a similar manner.

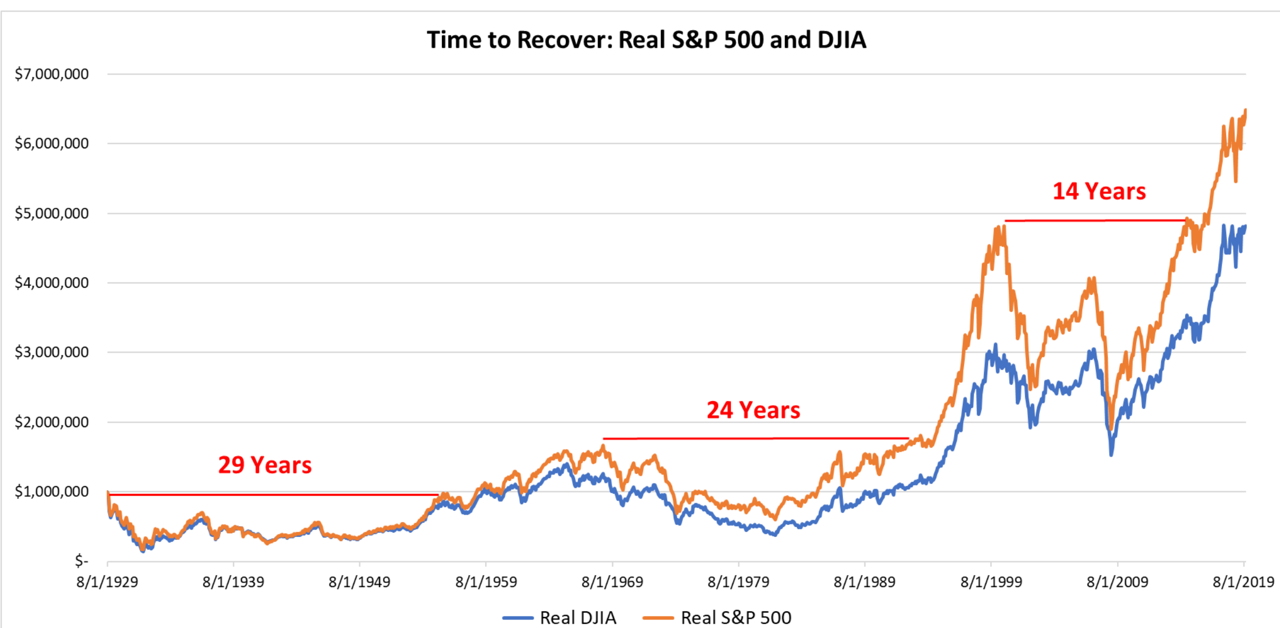
With that said, our team is working diligently to manage portfolios with the utmost conviction in these turbulent times. We continue to focus on preserving capital, while capitalizing on opportunities that have arisen due to changes in the market. While we, like others, do not know where the bottom lies, we are finding opportunities to buy convertible bonds we have not seen in a long time. Our experience provides wisdom and insight into this asset class and the markets as a whole. Managing through these turbulent times requires patience, discretion, and the ability to tolerate volatility. Our main objective, as always, is to find quality bonds that trade within our price range. Warren Buffet, the famous investor and CEO of Berkshire Hathaway, has been quoted saying: "Be fearful when others are greedy and be greedy when others are fearful." In this type of environment, fear is clearly prevalent and we are using that to our advantage.

Drawing from History: The Real Devastation of Bear Markets

With the passing of Paul Volcker, former Chairman of the Federal Reserve, we were reminded of his work during the 1970s and how market downturns can impact investors for years to come. History, especially in the world of investing and finance, is of particular importance. It has a way of reminding us of our mistakes, mistakes of others and how to avoid repeating them in the future.

In a recent article, that is exactly what we did. Time to recovery is important when investing. Until recently, you may have not paid much attention towards the potential for a down market. But, that is why history is an important lesson, particularly for younger investors, who may remember 2008 and maybe even 2000, but have only heard stories of down markets before then. The 1970s were a wakeup call for anyone living through that time period. It was the double whammy for investors, stagnating economic growth coupled with inflation. America was going through a time that many have called similar to today – a time of uncertainty and potential for change on the horizon.

In the investing world, time to recovery was especially important during this period. The graph below highlights three times in U.S. history and the subsequent time to recovery in real terms (adjusted for inflation). Getting



back to even is one thing, but we must account for inflation as well because your ability to purchase goods and services is what really matters. During this time, it took 24 years for an investor to get back to even in real terms. When compared to the 2000s, a period often viewed as the worst since the Great Depression, it took investors ten additional years to recover their investment.

We were very surprised by this information, to be frank, and believe it is important for clients to understand the potential effects of inflation. While inflation has been low of late, barely hitting 2% in most years, that does not mean it cannot rear its ugly head again.

Here at Wellesley Asset Management, we believe it is close to impossible to know when it's the right time to invest. That is why our focus is on carefully chosen, short-dated convertible bonds for investors. Convertible bonds earn interest during bear markets and return principal upon maturity, barring default, even if market downturns occur. Simply put, historically, convertible bonds have the ability to outperform both stocks and bonds over full market cycles and can provide positive "real" returns. This strategy is one that we have been executing for close to 30 years; attempting to minimize losses in devastating downturns while participating on the upside.

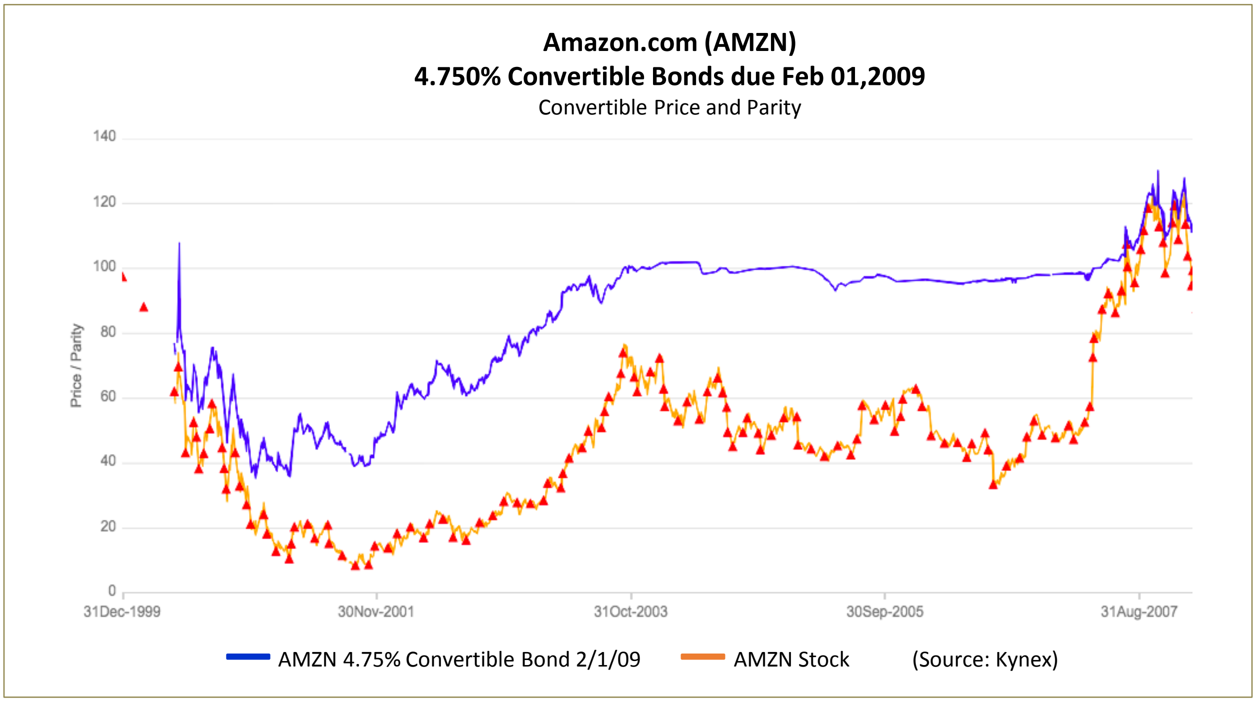
Stocks and the Wild Ride

The markets have been on a wild ride to start the year. The S&P 500 recorded its worst quarter since 2008, falling 19.6%. With the S&P 500 falling over 20% from its peak earlier on in the year, the 11-year drought of a bear market is officially here. With all of this volatility, we are reminded of prior downturns and how quickly the value of a stock, or entire sector, can fall. Within this article we'll focus our attention on two top blue-chip technology stocks, Microsoft and Amazon, and their path to success. While you may assume that their stories have always been constructive, due to their generation changing leadership and innovation, both have encountered bumps along the way. *This includes a time to recovery of nearly 16 years, just to break-even on the purchase of Microsoft stock during the dot-com bubble.*

Back in the late 1990s when technology stocks seemed to double on a daily basis, the notion that you could lose almost all of your money invested in technology stocks seemed outrageous. But, by the end of 2002, many of the dot-com and telecom companies had lost 95% of their value. Once you lose 95%, as you know, you do not need to gain only that amount to get back to even; you actually have to gain almost 1,900% to break even! Even the best of companies lost incredible value during this period of time. The market in the late 1990s rewarded any company with a dot-com at the end of its name. The exuberance for these companies was overwhelming. These companies saw fortunes made and lost at record speed.

For instance, a fantastic idea that just came out at a wrong time was Pets.com. It was a simple solution to purchase pet products for our fury friends online. The funding was strong with venture capital backing, along with an early stake from Amazon. The stock debuted with its IPO in February 2000 at $11 per share, but just two years after launching, it closed out at 11 cents per share, taking $300M in financing with it. There are countless other examples of companies that saw their fortunes evaporate extremely quickly during this time.

Microsoft and Amazon, two once in a generation companies that have changed the



lives of the entire world, but while both are still in business, were not immune to the market reaction during this time. During the buildup of the dot-com bust, a then famous hedge fund manager and now CNBC commenter, James (Jim) Cramer, proclaimed that Internet stocks are the only things worth owning right now. "These winners of the new world", as he called them, "are the only ones that are going higher consistently in good and bad days". While we are not taking any slight towards Mr. Cramer, we are simply pointing to the fact that not only did many companies go bankrupt; these two historic companies were abysmal investments for a long period of time.

Amazon, for example, took almost 10 years after the bubble burst to recover its value from its peak in 1999. This does not even account for inflation. If you were an investor during that time, you would have had to make the choice of remaining invested even during a period when the value of your shares went down from $106.69 to as low as $5.97 per share in September 2001. This, of course, would have been a challenging choice for anyone. On the other hand, Amazon issued a convertible bond in February 1999. As you can see in the chart, the convertible initially fell, in line with the stock, but by October 2003 was back to even (par). Investors in the Amazon convertible received their money back in less than five years, while investors in Amazon stock had to wait close to 10 years. Furthermore, while Amazon stock paid no dividends, an investor in Amazon's convertible bond collected interest payments of 4.75% annually while waiting to get back to even.

A similar story is Microsoft. Back in 1999 the stock reached its peak value of $58.72, but by the following year it had fallen over 63%. Investors in Microsoft did not get back to even until **almost 16 years later**! That can be the trouble with equity investing; a downturn can last longer than you may ever imagine. It is very hard to imagine an investor waiting 16 years just to break even from buying a stock, and that does not account for inflation.

While this time is of course different in many senses; we were not dealing with a global health pandemic back in the late

1990s, only the euphoria of the internet, yet many characteristics remain true. Investing in stocks involves a significant risk along with losses that can take decades to regrow. But with the Wellesley convertible bond strategy, our investors do not have to wait decades to get their money back. We purposely invest in short-dated convertible bonds with a maximum maturity of seven years to ensure we know when we will receive our money back, barring default.

Active Management with Convertibles

We are often asked and justifiably so, why should I invest in an actively managed convertible strategy when I could do it myself or use an index fund? In times where trading apps are extremely easy to use, index funds are readily available and information can be found at the click of a button, this is a fantastic question to ask. Within this short article, we'll explain a few considerations you may not have thought about before and shed some light as to why convertible bonds remain a unique area of the market for active management.

First off, as an introduction to the asset class, convertible bonds are a traditional bond combined with an embedded equity call option. A call option allows the investors the "option", but not the requirement, to purchase the security at a certain point in time. The hybrid nature of convertible bonds is one of the unique qualities of the asset class. Simply put, this allows investors the potential safety of fixed income with the possibility of equity-like returns. In theory, it sounds simple that an index fund could invest in convertible bonds and garner these benefits just as easily as an active manager. But, if an investor wants to gain the key benefits of convertible bonds, an index fund or going it alone are very difficult propositions.

For the investor that may say to him- or herself, why don't I just do it on my own? The answer requires a bit of an explanation and maybe an analogy will help. With most of us there are many things that we enjoy doing on our own. Fixing your car is one thing that comes to many of our minds. I'm sure we all know someone that has the ability, or sometimes not, to change their oil or even make major repairs. Depending on the car, the skill of the person and the job, this can range from simple to incredibly complex. Some car models, especially the newest most technologically advanced cars are near to impossible for the basic handy man to work on.

They require a trained technician, plus all of the tools to complete the job. Convertible bonds act in a very similar manner. The markets are designed for the institutional investor, such that if an individual attempted to buy a convertible bond, what investors call "bid-ask" spread, the difference between where an investor can sell a security versus where they can purchase it, would be incredibly large. This means that the price an investor either wants to buy or sell their bond would be either much higher or lower than the professional investor could receive. In addition, each convertible bond generally comes with a 100-plus page indenture (think owner's manual) with features that are unique to that issue. Similar to the trained car professional, doing it on your own may not be worth it.

The next stop for an investor is using either passively managed index funds or ETFs. The most popular ETF that tracks the convertible universe (Barclays U.S. Convertible Bond > $500MM Index), CWB, is a market capitalization weighted product. If you're familiar with our articles, you may be aware of our concerns regarding market capitalized weighted funds. Paying a reasonable price for the bond is central to our investing philosophy. We typically purchase bonds that are trading close to par value, usually 1000. This means that we do not purchase bonds that trade above a specified price range.

Think of this like going to the grocery store. If you go one day and you see that the pasta that you typically purchase is twice its usual price, do you purchase more? The answer for the rational buyer is NO! We have the same belief when it comes to convertible bonds. The purchase price is one characteristic that we can control in some regard and when it goes down, we are able to purchase more bonds for our clients at a discount. With a market capitalized weighted ETF, as the price increases, it is actually purchasing more of the higher priced bonds. You may ask yourself, why would this happen? The reason is the market capitalization weighted feature; as the market capitalization increases, the size within the index will increase.

As we all know, markets are dynamic and change on a daily, weekly, and quarterly basis, thus changing the profile and price of the bonds. That is why we believe it is very important to actively monitor and manage these risks throughout the life of the convertible bond. ETFs on the other hand, as discussed earlier, purchase more of the security as the price rises (buying more pasta when the price increases). Therefore, a term called portfolio management, is critical for investors. This is one of the jobs that we perform (the mechanic with the knowledge and tools). We consciously review the characteristics of the bonds that we own, so you do not have to. As the markets fluctuate, we are hard at work researching securities that meet our purchase criteria and then finding the best prices we can buy them for. This way you're able to sit back and spend more time on the things you enjoy.

Important Disclosures:

Past performance is no guarantee of future results. All investments, including convertible bonds, have a risk of loss.

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. This is not an offer to purchase securities.

Although information has been obtained from and is based on sources Wellesley believes to be reliable, Wellesley does not guarantee the accuracy of the information, and it may be incomplete or condensed. All investments, including convertible bonds, have a risk of loss.

Disclosures Pertaining to "The Markets and Convertible Bonds: A Plan to Stay the Course

Footnotes Pertaining to WIA Performance in the Years up to and Including 2009

The performance presented reflects model performance an investor may have obtained had it invested in the manner shown and does not represent performance any investor actually attained. Model returns have many limitations and may not reflect the impact that material economic and market factors may have had on the decision-making process if client funds were actually managed in the manner shown. The performance presented reflects the convertible securities portion of WIA's client accounts. Actual client accounts may include positions other than convertible securities and such other positions are excluded from the performance calculation. Accordingly, the actual return of WIA client accounts is different, in some cases substantially, from the performance presented for convertible securities.

WIA's convertible returns have been calculated using the methodology set forth below. Such methodology includes several assumptions that result from systems limitations on aggregating the convertible security portion of multiple client accounts. Although information has been obtained from, and is based on, sources WIA believes to be reliable, WIA does not guarantee the accuracy of the information, and it may be incomplete or condensed. 1. Listed the market value of all convertible securities held on the last day of each month. 2. Determined the weight of each security holding in the portfolio (individual security value / total security value). 3. Determined each security's return for the month (monthly interest earned plus / minus monthly price change). 4. Assumed that a security entered the portfolio on the first day of the month in which it was first purchased. 5. When a security was completely sold out of the portfolio, its prior month ending value was adjusted to reflect the final sales price. 6. Weighted each security's return for the month by the security's weight in the portfolio. 7. Summed each security's weighted return for the month to get the portfolio's return for the month. 8. Compounded monthly returns to calculate annual return.

Footnotes Pertaining to WIA Performance in the Years After 2009

Beginning on January 1, 2010, monthly returns are size-weighted average returns and have been compounded to calculate annual returns. The WIA Composite includes all client accounts consisting only of cash and convertible bonds. Effective January 1, 2015 the WIA Composite was redefined to include client accounts that hold unregistered 144A bonds. Accounts are included in the WIA Composite for the first full month under management and are removed from the WIA Composite at the end of its last full month under management.

Footnotes Pertaining to WIA Performance in the Years 2016 and After

Beginning January 1, 2016, the WIA Composite was redefined to add client accounts which may invest in WAM's proprietary mutual funds and excludes institutional client accounts and wrap accounts in the Wellesley Convertibles and Wellesley Institutional Capital divisions from the performance calculation. Wellesley Convertibles includes accounts which are fully discretionary wrap portfolios. Wellesley Institutional Capital includes institutional investors, including pensions, profit-sharing plans, defined benefit plans, defined contribution plans, hospitals and not-for-profit organizations.

Disclosure Pertaining to "Stocks and the Wild Ride"

Investments in convertible securities are subject to the risks associated with both fixed-income securities and common stocks. All fixed-income securities are subject to two types or risk: credit risk and interest rate risk. Lower rated fixed-income securities are subject to greater risk of loss of income and principal than higher-rated securities. 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. 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.

 DB04152020-1-151