Wellesley Asset Management Commentary | October 2020

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Third Quarter Update: The Safest House in the Neighborhood

The Refinitiv Wellesley Convertibles Index (RWC0) is a joint venture between Refinitiv and Wellesley Asset Management to create an index that represents Wellesley's absolute return seeking convertible investing style. We have often thought of our strategy as being one of the most conservative among its convertible bond peer groups. A recent sell-off in Tesla got us wondering how our strategy would hold up versus its convertible competitors and the convertible index. On September 8, 2020, S&P Dow Jones Indices announced that Tesla would not be added to the S&P 500 Index as had been highly anticipated. This led to the largest one day drop on record for Tesla with the stock plunging 21.06%, while the S&P 500 fell 2.78%. Tesla is the largest position in the Bank of America/Merrill Lynch V0A0 convertible benchmark, helping to push the index down 3.27%, and causing other convertible competitors to fall 1.84% on average. As demonstrated by its conservative nature and focus on capital preservation, the RWC0 only dipped slightly by 1.03%, participating in only 31% of the V0A0 Index's drop!

While one day's return cannot be relied upon to show how well a strategy may protect investors in a prolonged downside move in the equity markets, performance over a long-term bear market may be illustrative. In 2008, turbulence in the mortgage backed security market sparked an equity sell-off which led to the Great Recession. During that year, convertible bond competitors were down 32.35% on average, the V0A0 Index was down 33.01%, and the S&P 500 Total Return Index was down 37%. In contrast, the Refinitiv Wellesley Convertibles Index was only down 17.74%.

Of course, downside potential is one factor in determining the relative safety of an investment strategy. Standard deviation of returns, drawdown and time to recover are other important considerations. The one, three, five and ten-year standard deviation of the RWC0 was 20% lower than our peer group and 20%-30% lower than the S&P 500 Index and the V0A0 Index. This means our investors had to endure substantially less volatility during those time periods. With respect to the 2008 bear market, the Refinitiv Wellesley Convertibles Index had a smaller drawdown (24.16%) than the V0A0 Index (43.57%) and the S&P 500 (55.25%). In addition, it only took investors 10 months to recover their loss in the RWC0 versus nearly 16 months in the V0A0 Index and nearly three years in the S&P 500 Index!

While focused on reducing risk, the Refinitiv Wellesley Convertibles Index obviously strives for long-term performance, in particular over full market cycles. As of this writing, the S&P 500 is down over 10% from its recent high, making it a market correction. If equities continue lower, the safest house in the neighborhood may well become the most desirable house in the neighborhood.

Buy When Others Are Selling

BioMarin was founded in 1997 and develops therapeutic enzyme products to treat rare diseases. The company has six drugs on the market that treat diseases such as phenylketonuria (PKU), an enzyme deficiency, and mucopolysaccharidosis (MPS), a disease that prevents patients from metabolizing certain complex carbohydrates. In addition, the company has a number of FDA approved orphan drugs for rare diseases. Orphan drug status provides the company with the financial incentive of an extended period of exclusivity due to the limited addressable market. Lastly, the company has five drugs in the pipeline that treat diseases such as hemophilia, a blood disorder, and achondroplasia which treats disproportionate short stature.

BioMarin is a rapidly growing company. Given the success of its existing product portfolio and the potential success for its future pipeline of products, it's easy to see why growth equity investors are attracted to the name. Between 2014 and 2018, the company's revenues doubled. Furthermore, non-GAAP earnings per share are expected to grow 30%, 53%, 77% and 38% over each of the next four years. Like many growth stories, BioMarin's investors optimistically priced rapid revenue and product growth into their investment assumptions. Unfortunately, news that the FDA would require an additional two years' worth of data for Roctavian, BioMarin's hemophilia drug, sent the stock price down significantly. Growth investors exited the stock as one of the drivers of future profitability was delayed and a new level of uncertainty was priced into the stock.

The sell-off presented a fantastic opportunity to re-enter BioMarin and specifically their convertible bonds, especially in terms of the convertible's risk/reward paradigm. We previously owned BioMarin's convertible bonds in our strategies but sold them as they appreciated in price and the risk/reward trade-off became undesirable. With the pull back in the equity price, we are once again able to buy these bonds below par. While equity investors who buy the stock at the current levels might be "catching a falling knife" (buying a stock that will only continue to fall), as convertible investors, we can buy the convertible bonds with high conviction at the current levels.

Our conviction is backed by the fact that BioMarin has a very strong balance sheet. The company has substantial liquidity metrics with $1.38 billion of cash and cash equivalents and a current ratio of 3:1. BioMarin's three convertibles (one maturing next month) are the only debt on the balance sheet and the company has a $200 million revolving line of credit which it has not used. In addition, the company has tangible equity of $2.6 billion and a debt to tangible equity ratio of less than one. Given BioMarin's liquidity and low leverage, purchasing the convertible bonds below par affords the potential for considerable principal preservation.

Unlike growth investors who may sell equity once a company's growth story is no longer intact, time, and the relative safety of bonds allow convertible investors to be patient and see if the company's growth story returns. We own two BioMarin convertibles that mature in four and seven years, and barring default we will be paid a coupon while we wait. New stock investors may be worried that this may not be the bottom for the stock, or further product pipeline delays may occur. Convertible investors, on the other hand, know that their investment is backed by the credit of the company allowing them to buy when others are selling.

And the Winner Is …

Markets hate uncertainty and investors do not like volatility. Unfortunately, both of these situations could present themselves as a result of the Presidential elections this fall. A landslide victory by either candidate will have its own market implications, especially when combined with the outcomes of the races in the Senate and the House of Representatives. A contested Presidential election, however, could have the most treacherous outcome for the financial markets. The COVID-19 pandemic has created a unique circumstance as the election outcome may not be known for weeks, if not months, after the election.

In 2016, 25% of voters mailed in their ballots. This year, due to COVID-19, it is estimated that more than 50% of voters will cast their ballots by mail. Further complicating the situation is the fact that each state has different laws about when ballots are due and when they can be verified. This may lead to uncertainty and the delay of election results. In response to this, some have suggested moving the date that the Electoral College meets to officially determine the outcome from December 14, 2020 to January 2, 2021.

Compounding the possibility of market volatility is the fact that Republican candidates are urging in-person voting while Democrats urge early and mail-in voting. One can envision a scenario in battleground states where early on it looks like a Republican victory but as mail-in votes are counted, the Democrats take the lead. In the end, either side could refuse to accept the results creating even more uncertainty. There is a precedent for an election where the results were not known immediately. In the contested election of 2000, it took five weeks to determine the outcome of the election. In November of that year, the S&P 500 was down close to 10% and the NASDAQ dropped 19%.

Convertible bonds may help protect investors from market volatility. If election results are favorable for the markets, convertibles can participate in the market upside. However, if the election results are not known for an extended period of time, and the equity markets have a large sell off, convertibles may offer a greater level of capital preservation than equities. In times of uncertainty, the asymmetric returns of convertible bonds may provide a winning option that investors should consider.

Past Performance is not indicative of future returns.

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.

The Refinitiv Wellesley Convertibles Index ("RWC0") is a joint venture between Refinitiv and Wellesley Asset Management, Inc. ("WAM"). RWC0 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 constituent holdings and their weighting in RWC0. RWC0 performance from its inception date of January 1, 2000 to February 2002 is representative performance based upon actual trading of convertible bonds in WAM client accounts. Thomson Reuters (now Refinitiv) became the calculation agent for the index in 2013.

The S&P 500 Total Return Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market exchanges; the New York Stock Exchange and the NASDAQ. The S&P 500 Total Return Index calculates the performance of a group of stocks assuming that all dividends and distributions are reinvested. The Bank of America-Merrill Lynch V0A0 Index represents all U.S. convertibles, excluding mandatory convertibles, small issues and bankruptcies.

DB10162020-2-375