

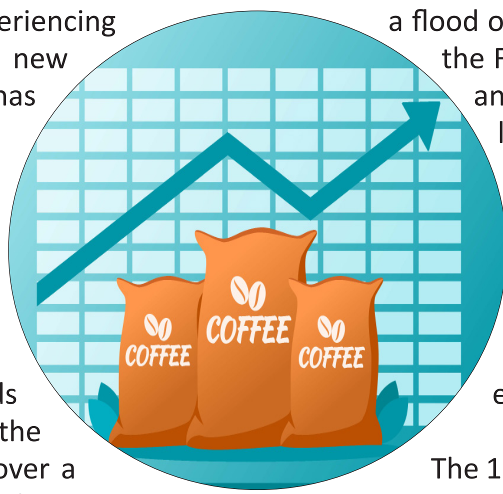
THE CONVERTIBLE INVESTOR
SUMMER 2021

Financial *focus*

ADDRESSING THE NEEDS OF INVESTORS AND PLANTING THE SEEDS FOR A SECURE FUTURE.

Inflation is Rearing its Ugly Head - Is Your Portfolio Ready?

Have you noticed your dollar not stretching as far as it once did? The most noticeable examples are gasoline and housing prices over the past year even consumer goods such as coffee have spiked in part due to shortages. What we are experiencing is price inflation. While not a new phenomenon, inflation has remained low for quite a while.



Up until recently, price increases have been seemingly non-existent. Since the 2008 Global Financial Crisis, inflation has increased by about 1.6% per year. For example, if a basket of goods and services cost $1.00 then the price of the good rose in price over a 12–month period to $1.016 the following year. Fast forward to today -- a basket of goods and services as measured by the Consumer Price Index (CPI) rose 5.4% on a year over year basis in June, 2021- the largest increase since August of 2008. Not only are prices increasing rapidly when compared to the previous year, but they are accelerating each month. June's prices increased by almost 1% from May. Even more alarming -- core prices (excluding food and energy) were up 0.8% from May to June- the greatest monthly price increase since June 1982!

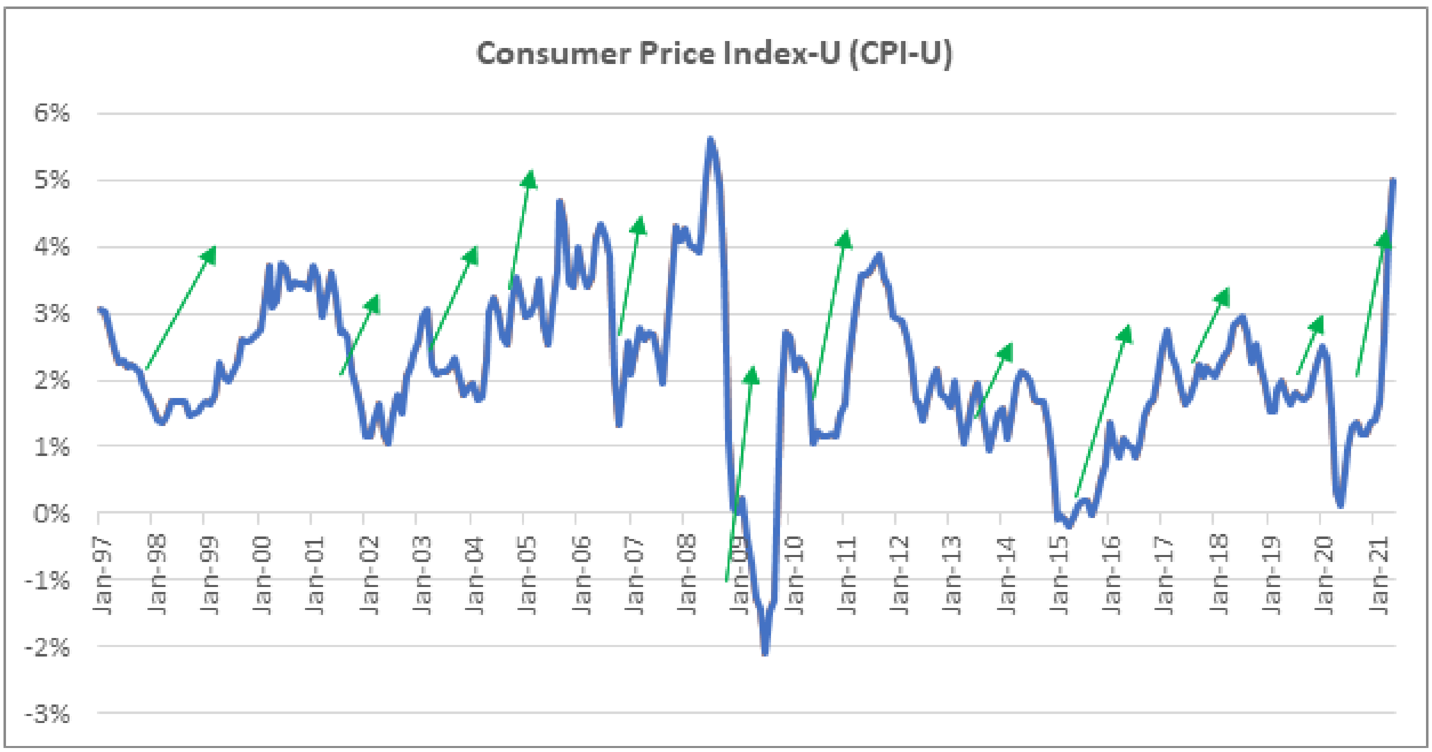
This has left not only consumers but investors concerned over inflation. This was not unexpected with a flood of monetary stimulus being provided by the Federal Reserve's bond buying program and fiscal stimulus via Federal and State legislation in the form of consumer and employment packages, inflation was bound to become an issue. Add in another potential fiscal stimulus package in the form of an expected infrastructure bill and actual inflation and more importantly inflation expectations may tick even higher.

The 1970's were an example of the devasting impact inflation can have on purchasing power and consumer confidence. More troubling, inflation can be particularly challenging for retirees and individuals with a lower risk tolerance or those investors with high allocations to fixed-income type investments. As overall prices for goods and services rise, real purchasing power is reduced almost without detection. If a fixed income portfolio yields 3% per year, but inflation averages 5% per year, real purchasing power decreases by 2% per year. In "real" investment terms, an investor is losing money even though the value of their investment portfolio may be growing.

Few investment professionals have first-hand experience with rampant inflation such as experienced during the late 1970s. The period was the culmination of almost a decade of intensifying energy prices, low GDP growth and rising interest rates. Average year-over-year inflation when calculated on a monthly basis was greater than 10% between 1979 and 1981. While traditional fixed-income securities struggled due to rising interest rates and declining prices, that same period of accelerating inflation showcased the investment advantages of convertible bonds.

Analyzing convertible securities' performance as provided by Morningstar helps to better understand how the asset class fared from January 1979 to December, 1981. During that time frame, the Convertibles Morningstar category outperformed both the S&P 500 Index and the Bloomberg Barclays U.S. Aggregate Bond Index by 7.30% and 18.01% respectively per year.

Although to a lesser degree, inflation has been present in other periods over the past 20 years. Below is a chart that shows Consumer Price Index (CPI) monthly change between 1997 and 2021. The green arrows highlight periods where the CPI rose above the 2% Federal Reserve target (trough to peak).



Source: bls.gov

The chart below highlights those "inflationary" periods and compares Wellesley's historic returns as represented by the Wellesley Investment Advisors composite with the Bloomberg Barclays U.S. Aggregate Bond Index. On average, the Wellesley clients returned a nominal 6.77% during those periods, while the Bloomberg Barclays U.S. Aggregate Bond Index delivered a nominal 4.17%. Again, these nominal returns would be less in real terms after considering the deleterious impact of inflation.

Wellesley Investment Advisors Net Composite* When CPI Year-Over-Year Rose Above 2%

	Wellesley Investment Advisors Composite (Net)	Bloomberg Barclays U.S. Aggregate Bond Index
4/1/1998 – 3/31/2000	24.34	7.92
7/1/2002 – 2/28/2003	6.29	6.51
3/1/2004 – 9/30/2005	1.43	3.49
11/1/2006 – 7/31/2008	3.40	7.46
8/1/2009 – 12/31/2009	6.87	1.26
12/1/2010 – 9/30/2011	-3.35	6.65
2/1/2015 – 2/28/2017	6.14	2.94
7/1/2017 – 7/31/2018	2.66	-0.8
3/1/2019 – 1/31/2020	6.31	7.64
6/1/2020 – 4/30/2021	13.60	-1.35

Wellesley's strategy of balanced convertible bonds has historically provided competitive returns even during periods of increasing inflation and has historically delivered positive real returns during periods of rising prices. Positive real returns provide comfort to investors that their portfolio keep up with inflation and avoid the devastating impact of higher prices on investors and consumers alike. With an allocation to Wellesley, feel free to enjoy that cup of coffee even though it costs a bit more!

Downside Protection: A Case Study of Wellesley Asset Managements returns in 2008

For many investors, 2008 seems like a distant memory. It's difficult to imagine a year when the S&P 500 was down 37%, especially given the raging bull market over the past 13 years. But it did happen, and it could happen again. The Great Financial Crisis of 2008 is a reminder that a well-managed portfolio can help control risk by moderating large drawdowns and lessening the impact of increasing stock market volatility. Specifically, stock losses began to accelerate as 2008 progressed forcing many investors to sell stocks in order to reduce risks and avoid further losses. In contrast, Wellesley's convertible strategy provided investors with less down-side risk.

The closing months of 2007 set the stage for what would be a devasting 2008 for the financial markets. A slowing economy contributed to lower housing prices, putting many recent homebuyers in the position of owing more on their homes than what they were worth. Many sub-prime borrowers were experiencing sticker shock as the ultra-low "teaser" interest rates on their mortgages expired and ratcheted up to prevailing market interest rates. Banks who had bet big on sub-prime mortgages faced severe losses as property foreclosures accelerated.

In January of 2008, the bad news continued as GDP grew only 0.6% in the fourth quarter of 2007, existing home sales declined to their lowest level in ten years, and the economy lost 17,000 jobs. In March, the Federal Reserve stepped in to save a failing Bear Stearns as it faced massive writedowns of mortgage backed securities. In addition, in the first quarter of 2008, the Federal Reserve lowered rates from 4.25% to 2.25% in an effort to spur economic growth. Despite these actions, the S&P 500 sank almost 10% in the first quarter of 2008 as the financial crisis rippled through all sectors of he economy.

Although Wellesley's portfolios were not spared, the damage was minimal when compared to the S&P 500 Total Return Index. Despite large positions in financial companies, the Wellesley Investment Advisors Net Composite* (the "SMA Composite") performance was down 1.18% in the first quarter of 2008. This out-performance highlights Wellesley's investment process which favors quality companies with strong balance sheets. Money center banks who invested heavily in sub-prime mortgages were screened out during the investment selection process due to their reliance on large amounts of leverage. Similarly, mortgage REITs were not considered because of excessive leverage in their business models. Instead, Wellesley's financial exposure focused on conservative regional banks and REITs that invested in commercial property such as office, retail and industrial space.

The second quarter provided a breather for the domestic markets. But the crisis began to move overseas as the International Monetary Fund (IMF) warned that global sub-prime losses could approach $1 trillion. Sub-prime mortgage lender New Century filed for bankruptcy in the U.S. and the Federal Reserve lowered the federal funds rate to 2%. The S&P 500 Total Return Index was down just over 2% for the quarter and nearly 12% for the first six months of the year whereas the SMA Composite was down 1.18% for the quarter and just over 2% for the half year again delivering outperformance. Two factors led to Wellesley's outperformance in the first half of the year: 1) the quality of financial holdings was much stronger than the S&P 500 Total Return Index, and 2) the focus on value-oriented companies versus growth-oriented helped to protect returns as the market downturn extended beyond financial stocks.

Bailouts and bankruptcies made headlines in the third quarter of 2008. US government-sponsored enterprises Fannie Mae and Freddie Mac along with insurance company giant- AIG were bailed out during the quarter while mortgage lenders Indy Mac Bank and Washington Mutual and reowned Wall Street investment bank Lehman Brothers declared bankruptcy. Late in the quarter, the Troubled Asset Relief Program (TARP) was sent to Congress as a means of rescuing failing companies. However, this bill was voted down on the Senate floor. Panic selling ensued and no asset class was spared. That day stocks sold off 8.30% while Wellesley's SMA composite was down 7.58%. It is important to note that when markets have sharp selloffs, the Wellesley strategy sometimes does not provide immediate downside protection as investors "throw the baby out with the bathwater", but when measured over longer time periods, the Wellesley approach of buying bonds near or below par has been able to protect investors from protracted equity downturns.

The fourth quarter proved to be the worst three months for the stock market in 2008. Although the TARP bailout bill was eventually passed, the economy started to falter as job losses increased and GDP growth turned negative. The economy officially entered a recession despite the fact that the federal funds rate dropped to zero and the Federal Reserve initiated the first round of quantitative easing. As the worst financial crisis since the Great Depression progressed, many investors reduced positions in the riskiest parts of their portfolios. As a result, the S&P 500 Total Return Index was down almost 23% for the quarter.

Wellesley's convertible strategy fared much better with the SMA composite falling only 2.93% in the fourth quarter of 2008. Fourth quarter performance highlights another key tenet of our investment philosophy: invest in shorter-dated bonds. Although there are convertible bonds with maturities beyond 20 years in the convertible market, Wellesley typically invests in bonds that mature within 7 years. In addition, we ladder maturities which means the average maturity is much shorter than 7 years. This provides date certainty and comfort that barring a default principal will be returned at maturity. Unlike bonds, equities do not have maturity dates and expose investors to greater future uncertainty.

The financial crisis of 2008 turned out to be disastrous for equity markets with the S&P 500 Total Return Index down 37%. Wellesley convertible investors were not immune to losses, but on a relative basis fared much better. Wellesley's SMA composite was down 12.65% in 2008. A focus on investing in high quality, short-dated convertible bonds issued by companies which trade at reasonable valuations helped limit Wellesley's investors from a devastating 2008. By avoiding substantial drawdowns, it became far easier to stay fully invested and reap the benefits of rapid asset appreciation and the start of a new bull market which began in 2009.

The Rational Investor?

The behavior of investors acting rationally versus irrationally is the subject of academic papers and discussions leading to two narratives – efficient market theorists versus proponents of behavioral psychology. "Conventional economics assumes that people are highly rational – super-rational – and unemotional. They can calculate like a computer and have no self-control problems", according to Richard Thaler, 2017 winner of the Nobel Prize for Economics. Unfortunately, as a result of various biases, investors often act irrationally, and like most things in life, investment behavior likely rests somewhere in the middle.

Generally speaking, over the past many years, we have experienced higher and higher equity prices. The stock markets never seem to go down and when they do, the sell-offs are often brief and quickly met with new all-time highs. This constant reminder of markets setting new records and media talking heads often reminding the general public that stocks go up, regardless of valuations or the down-side risks of investing, quickly leads to something known as Regret-Aversion Bias. Regret-Aversion Bias is the idea that one avoids decisions out of a fear their decisions will turn out badly. In some ways, it is the notion that the "status quo" is the appropriate state of being. In terms of investment decisions, it often leads to herding behavior as investors feel safer among the crowd. The old adage, "if it isn't broke don't fix it", comes to mind. For those with substantial equity exposure and outsized returns, Regret-Aversion Bias may curtail the idea of taking profits or reducing risk even when risks become elevated. If everyone is in the stock market and the experts say it's the right place to be, why sell?

That tends to be compounded by Confirmation Bias. Confirmation Bias occurs when investors seek out information that confirms their general beliefs. We hear what we want to hear. It causes investors to consider only the positive information about an investment and ignore new information that would contradict their investment thesis. Confirmation Bias likely results in skewed perspectives about the markets or investments and eliminates the idea that there are two sides to every story. With markets at all-time highs, it is likely Confirmation Bias that is driving investors to see the glass half full as opposed to half empty, and may cause investors to ignore apparent risks. Investors gravitate toward news stories or listen more attentively to commentators communicating that equities are the ideal investment even though facts, investing environment or valuations have changed. Not only do investors hear what they want to hear, but they tend to seek out information that confirms their beliefs.

Finally, Endowment Bias occurs when investors feel their current investment is worth more than the same price they would be willing to pay for it. When you own an asset, your perception of its value is generally far higher than if someone else owned the same asset. Unfortunately, that's incredibly common in life, but maybe even more so when discussing asset valuations. It makes investors reluctant to sell certain investments they already own and will often lead to a sub-optimal asset allocation. It often causes investors to double-down on an investment even though the investment thesis has changed, or to never sell their winning investment. Many investors who own an appreciated asset may never think about selling that appreciated asset; while at the same time may never consider purchasing that same asset because they consider it grossly overvalued. To wit -- my shares of Microsoft are a great investment, whereas the shares trading in the open market are a poor one with limited upside and considerable risks.

These are just some of the many biases that impact investor behavior and cause them to act irrationally. A bias toward the familiar is why many invest in assets they feel they know well rather than in a properly diversified portfolio. The known feels safe while the unknown feels risky. It is prudent to understand what is in your portfolio, but reckless to not explore ways to diversify and reduce risk.

Emotions and herd instinct can play a key role in buy and sell decisions. These were likely important components of the 2000 tech bubble, the 2007 housing mania, and the 3-month market crash of 2020. If everyone owns AOL common stock or is making money flipping houses, then why not me? If everyone is selling stocks, I should jump on the bandwagon too. It can cause many money managers to chase performance, drift in terms of their investment style, or often ignore the benefits of diversification when it is needed most.

Given it is impossible to completely remove biases from investment behavior and act rationally, it becomes critical to have an investment plan and maintain perspective. As we have all been taught, "don't make decisions in the heat of the moment." Chasing performance or increasing risk during periods of elevated risks is not wise and is irrational. Selling a stock after a large drop, even though fundamentals have not changed or possibly improved, is not prudent. You drive a different speed on the highway depending upon the weather conditions. Just because others are speeding during a torrential rainstorm does not mean it is sensible to hit the gas pedal. The downside risks are too great, and with a bit of perspective, you know that you will reach your destination with far greater certainty if you act rationally.

At Wellesley Asset Management, we have a time-tested process that hopefully limits many investment biases. As has been the case for 30+ years, we focus exclusively on convertible bonds issued by profitable companies. We attempt to avoid exposure to over-valued securities and do not chase performance. Our emphasis on convertible bonds provides a reasonable balance between the upside benefits of equity and the potential downside protection of debt. Our team of investment professionals brings varied perspective to the markets and hopefully constructs portfolios that are not imbued with individual biases. When facts or risks change, the Wellesley team becomes tactical and adjusts their investment outlook, rebalancing the portfolio if needed.

Our approach has more often than not proven successful in all types of markets. Unlike many other investment managers, we have a plan that has a long-term focus which allows for perspective even during brief market aberrations. As frequently communicated, we are not short-term investors or market-timers, and may underperform over a month or quarter. But, over the medium and especially longer-term, or as we refer to as "full-market cycles", our performance speaks for itself. Our time-tested investment strategy and defined process help remove many investment biases and facilitate the construction of more "rational" portfolios.

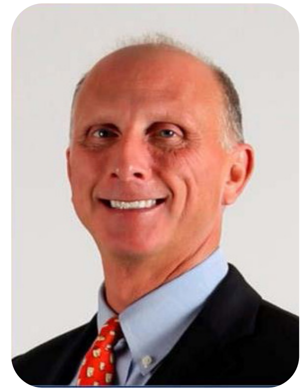
We understand biases exist. But we work very hard to eliminate those biases from our investment process as we build all-weather convertible bond portfolios. As Warren Buffet so aptly states, "The chains of habit are too light to be felt until they are too heavy to be broken."

Q&A
with the Portfolio Managers

Greg Miller
CPA, CEO, and
Portfolio Manager

Michael Miller
CFIP, President, CIO,
Portfolio Manager

Jim Buckham
CFA,
Portfolio Manager



Howard Needle
Portfolio Manager

Q: Can you spend a moment to review the investment process that the team employs?

Our investment process is two pronged: we analyze macro conditions and then build a portfolio of convertible bonds issued by high-quality companies. We try to source convertible bonds which we believe to be attractively priced and that coincide with our macro views. We like to say that we "marry" macro and micro in order to construct an all-weather portfolio of convertible bonds.

More specifically, the portfolio management team and research analysts pore over various data and markets trying to identify attractive convertible bonds that fit our investment thesis. We begin to construct a portfolio convertible bond by convertible bond, with a goal of sector diversification. Once constructed, the portfolio is continuously monitored with an eye toward changing fundamentals and prices. If an investment thesis behind an investment changes, we rebalance the portfolio either reducing or removing positions to reflect the changing outlook.

Q: Please talk about the investment environment for convertible bonds over the past six to twelve months.

There has been a substantial rise in new issuance which provides increased profit opportunities, and allows for a de-risking of the portfolio as appreciated securities are replaced with new ones. A strong new issue calendar also is reflective of the overall health of the convertible market.

Increased volatility has also been a positive catalyst as convertible bond prices are positively correlated to higher volatility. Because of the option to convert a convertible bond into common stock, increased periods of volatility often act as a tailwind for the asset class.

Finally, credit spreads have improved reflecting better credit metrics and improving fundamentals. The substantial amounts of liquidity being provided via monetary and fiscal stimulus have trickled onto corporate balance sheets. Improving credit conditions are a fundamental lynchpin behind successful convertible investing.

Q: In this investment environment, how did you manage portfolios?

As we have often communicated in the past, the management of our convertible bond portfolios is no different today than over the past 30+ years. Our investment process and plan remain the same. We manage the portfolio utilizing a time-tested and successful investment approach of constructing a convertible bond portfolio that consists of high quality and profitable companies. We populate the portfolio with balanced convertible bonds that provide upside equity participation and the downside protection that debt typically affords over equity.

Although the markets may be different, our approach in this environment is no different than past periods. We have a plan and investment process and stick with it knowing that success has been achieved in a variety of markets while utilizing our time-tested approach. We take a long-term approach and realize that market-timing is nearly impossible.

Q: What factors do you think are most important for investors to watch in 2021?

We have become increasingly concerned about general equity valuations and the risk of a substantial drawdown in equities. Consequently, we have reduced many equity sensitive convertible bonds, and replaced with more fixed income sensitive securities.
There seems to be an "everything bubble" in place as never-ending monetary and fiscal stimulus have pushed all different asset prices to unprecedented levels. This is likely unsustainable and we are positioning our portfolios as such.

Q: What are the main differences between the products offered by Wellesley Asset Management?

We offer a variety of products all based on the same investment process, but with varying degrees of risk. At our core, we are convertible bond experts and investors and try to stick to our knitting. Each of our product offerings are convertible bond-centric, but with varying degrees of risk. Our flagship mutual fund invests primarily in balanced convertible bonds and is the broadest measure of the convertible bond market. Our conservative bond fund focuses on shorter duration convertible bonds and more bond-like convertible securities. Finally, our most flexible mutual fund is one that is slightly more aggressive and designed to replicate a hedge fund but in a mutual fund wrapper. It is a mutual fund that utilizes modest leverage, but which simultaneously hedges a variety of idiosyncratic and market risks via multiple hedging techniques. We also offer two private hedge funds which are the most aggressive of our strategies. The hedge funds employ leverage and are less constrained in terms of position or sector concentrations.

Disclosures

Past Performance is not indicative of future results. This presentation is meant for broad discussion purposes only and is not intended as a recommendation to buy or sell any security. The reader should not rely on this information for investment purposes.

An investment in convertible securities involves a risk of loss and may not be suitable for all investors. 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.

Awards and rankings should not be viewed as representative of any one client's experience and should not be taken as an indication of performance by Wellesley Asset Management ("WAM") and any of its clients. Working with a highly rated adviser does not ensure that a client will experience a higher level of performance or guarantee results.

A direct investment in an index is not possible.

*No representation is made that the investor will obtain similar results to those shown. The performance presented may not be representative of investments held in any one client account or performance realized in any one client account. An investor's actual performance may differ from the performance presented due to timing of investment, contributions and withdrawals. Performance does not reflect the effects of taxation, which may result in lower after-tax returns.

Returns are net of management fees shown. Returns reflect the reinvestment of interest and dividend income. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Standard WAM management fees are set forth in WAM's Form ADV Part 2A. Returns later than December 2019 should be viewed as preliminary and used for informational purposes only. These returns have the potential to be adjusted until audited and any such adjustments would be made without any notification.

Footnotes Pertaining to WIA Performance in the Years Up to and Including 2009: The performance presented reflects performance an investor may have obtained had it invested in the manner shown and does not represent performance any investor actually attained. These 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 WAM'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 WAM client accounts is different, in some cases substantially, from the performance presented for convertible securities.

WAM'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 WAM believes to be reliable, WAM 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.

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