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2nd Quarter Update

On the heels of an abysmal February and March for equity-centric investors, market participants were rewarded during the second quarter. The S&P 500 was up 19.9% for the largest quarterly gain since 1998. Similarly, the Dow Jones Industrial Average (DJIA), the Russell 2000, and the Nasdaq Composite recorded their best quarters since 1987, 1991, and 1999 respectively. Convertible bonds performed extremely well in response to the strong returns in the equity markets. The Refinitiv Wellesley Convertibles Index (RWC0) was up 16.43%, capturing approximately 83% of the S&P 500 upside. The impact of higher stock prices and tighter credit spreads dwarfed the minor headwind created by lower volatility as convertible valuations improved dramatically.

On the economic data front for the quarter, it was a mixed bag. Reopenings of cities and towns across the country staggered by state with some seeing a rise in the number of COVID-19 cases. Others states have moved more slowly and have seen a reduction in the rise of cases with businesses moving towards some sense of normalcy. This a situation we are monitoring closely and how it impacts the companies we invest in.

For the companies we invest in, we are paying particular attention to the debt side of the equation. As you know, this is less important during good times, but in periods of slowing economic growth or contraction, the companies with reasonable balance sheets tend to hit their stride. While the second quarter may have been one for the ages, it is hard to imagine the third quarter will be a repeat. In the beginning of July, we learned that the unemployment rate was still above 11%. Throughout July and August, we have seen second quarter earnings released with largely decent numbers from companies. Most of this was due to the drop in expectations from investors and has been a boon for markets. Companies and governments have raised record levels of debt during these times. This will be particularly important if the recovery is not "V-shaped."

In terms of issuance, convertibles joined the party of the capital markets during the quarter, issuing over $45 billion in new paper. This one quarter is larger than any entire year between 2010 and 2017. Also of importance for our market is the decreased amount of redemptions by companies (puts, calls, maturities, and buybacks). This allows investors to have more options for selecting companies and provides new bonds to purchase near par. Currently, the size of the convertibles market is approaching $300 billion. This figure has grown steadily similar to its peak back in 2007 before the financial crisis.

A friend of the firm, Howard Needle, recently wrote an article titled, "Why Convertibles Now," and described a relationship we have viewed in the markets during our 25-plus years of investing. This is the correlation between the convertible bond market size and overall valuation. For instance, in 2000/2001 and 2007, he writes, the convert market size cyclically peaked at $218B and $313B respectively. But what is interesting is that over the past 10-plus years, convertibles have lagged from both a market size and valuation perspective. According to Howard, convertibles should be expensive (rich) but are actually cheap. Quantitatively, convertibles are approximately 3% cheap relative to their underlying equities. Current valuations are the cheapest that they have been since 2005 (4% cheap) and 2009 (10% cheap). Howard writes extensively on this in the article, and we have witnessed the same in our portfolios. To further these points, investors have been purely focused on equity markets over the past 10 years as a rising tide has pushed all markets higher. This was in an environment of generally declining interest rates (positive returns for fixed income investors) and extremely strong stock market performance. In our view, the next 10 years will look very different.

During the quarter, we participated in 13 new deals that were issued in our market. The size and scope of each deal varied, but a few of particular interest were PETIQ, Callaway and Livent Corp. We were able to secure sizeable allocations of each of these and each have participated nicely since issuance. PETIQ is a pet medication and wellness company specializing in medications to treat diseases along with preventive medication. The deal was attractive for the coupon, 4%, along with the quality of their balance sheet. Callaway, the golf and apparel company, issued a convertible back in May in which we were able to secure a significant allocation of the deal. The company is attractive for their upside potential, holding significant market share in the golf business, combined with a high-quality balance sheet. Livent Corp, issued in June, produces lithium chemicals used in batteries and pharmaceuticals. The deal provides exposure to a growing company and industry, combined with a significant coupon at over 4%. We have been pleased with the short-term performance of these new issues providing yield and upside performance to the portfolio.

We also issued two new synthetics during the quarter, McDonald's and Johnson & Johnson. Both provide exposure to the blue-chip Dow Jones Industrial Average (DJIA). McDonald's, for instance, provides exposure to an industry that has done very well during downturns with consumers seeking out less expensive food alternatives. Additionally, we like that McDonald's is simplifying their menu, producing cost reductions across the supply chain. Johnson & Johnson is a Fortune 500 healthcare company that has solid brands such as Tylenol, Aveeno, Neutrogena and Zyrtec. These are products that have tended to be non-cyclical in nature.

What seems to separate the market outlook of the bulls and bears is the length of time that COVID-19 will continue to dampen economic growth. The bulls are looking past the next quarter for a time when the economy will return to normal. The bears, looking at the resurgence of COVID-19 cases, believe we could be in for a prolonged economic downturn. At Wellesley Asset Management, we try not to predict the future of the markets. Rather, we remain invested in an asset class that according to Barclays, "offers attractive risk-controlled equity exposure, income, and a lower duration at a time of continued economic uncertainty and risk-asset valuations that are baking in an economic recovery."

Past performance is not indicative of future results.

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

An investment in convertible securities involves a risk of loss. The value of an investment in convertible securities may decrease as well as increase.

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 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. The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock Market. Today the NASDAQ Composite includes over 2,500 companies. CS08102020-1-301