The Convertible Investor

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

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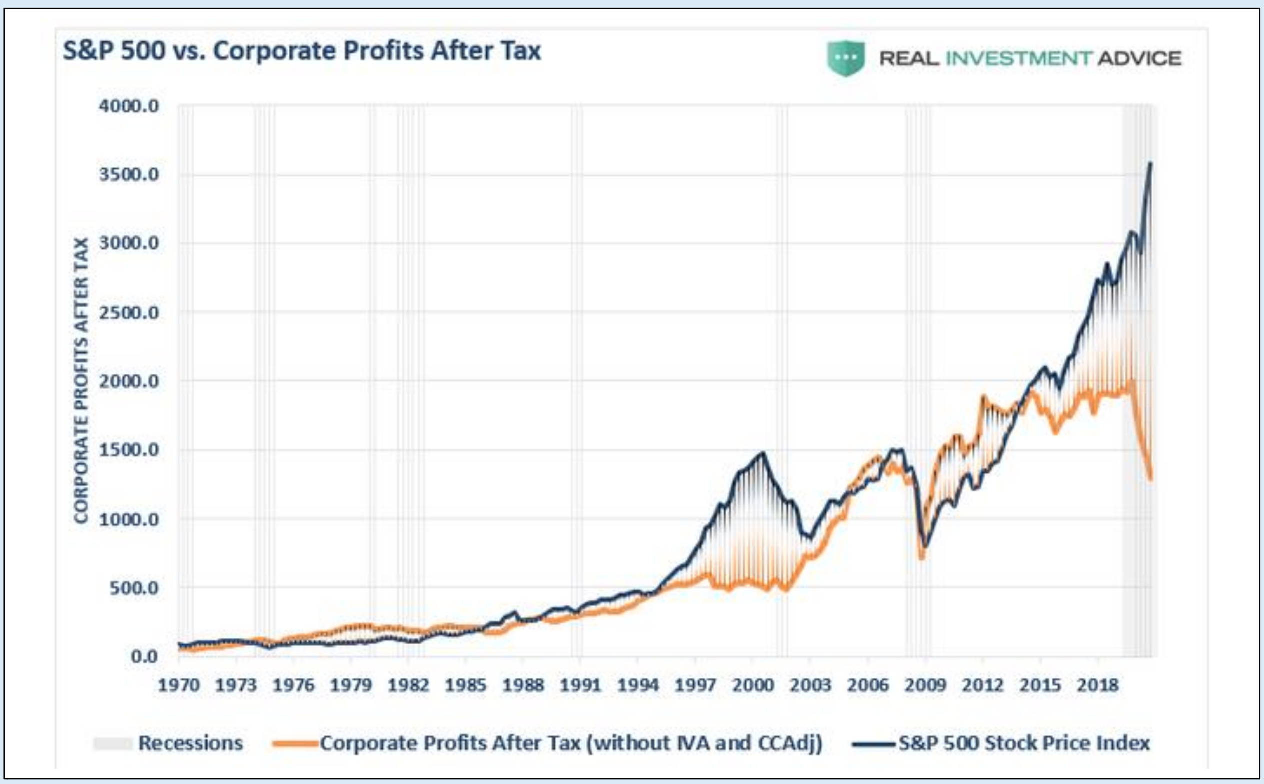

The present situation within the markets, appears familiar to us. Above is a chart representing the value of the S&P 500 over time versus corporate profits. As you can see, the environment we are in today, looks eerily similar to the early 2000s, in which the S&P 500 TR Index fell 37.61% between 2000 and 2002. During this time, the Refinitiv Wellesley Convertible Index (RWC0) rose 34.10%.

Wellesley Asset Management's Investment Process: The Three Legs of the Stool

In order for a stool to be sturdy, it needs three strong legs. Similarly, when we are vetting new investment ideas at Wellesley Asset Management, we consider three strong metrics when considering a new investment: the balance sheet, income statement and the convertible bond itself. Just like a wobbly stool with a weak leg, if any one of these areas does not meet our research criteria, the investment will not provide our clients with a strong investment foundation.

Our research process starts with the balance sheet because in our view *return of principal* is more important than *return on principal*. The balance sheet gives investors insights into a company's cash position, use of leverage, and its ability to pay off its debts. We look at the current ratio (current assets/current liabilities) to determine a company's short-term liquidity. The quality of a company's assets also figures into our analysis. We pay particular attention to the amount of intangible assets, (goodwill, patents, trademarks, etc.) which we view as inferior to tangible assets. Intangible assets are often inflated in company balance sheets. Leverage ratios (debt to equity) are important to consider in our analysis to determine the level of risk a company employs to run its business. Finally, we look at a firm's capital structure and overall debt load on its balance sheet before making an investment. If a company has strong metrics in these investment criteria, we feel comfortable the firm will be able to pay off the convertible bond at maturity.

The next step in our investment process involves analyzing the income statement. We like to see a strong history of positive earnings on both a GAAP and non-GAAP basis. Furthermore, we look for positive analyst earnings estimates for the coming years. In an effort to determine if a stock is expensive or cheap, we compare these estimates to where the stock is trading to determine the forward price/earnings ratio (P/E). As a last step, we compare the P/E ratio to the anticipated growth rate of earnings to see if the value of the stock is worth it when compared to future growth prospects (PEG ratio). The income statement can also give us insights into the profitability of the company by looking at gross margins and earnings to sales ratios.

If a company has a solid balance sheet and a good income statement, we next look at attributes of the firm's convertible bond. In this respect we like to look at the relationship between a bond's yield and its conversion premium (difference between a convertible's current price and its conversion value). Obviously, we prefer higher yields and lower conversion premiums, but sometimes we buy convertibles that only have one of these attributes. In addition, we prefer to buy bonds that have a least one year until the next put, call or maturity to give the investment time to work. However, we avoid longer termed bonds beyond a seven-year time horizon in an effort to mitigate interest rate and business risk. Finally, we look at the convertible bond's delta to determine its sensitivity to the underlying stock.

Wellesley Asset Management has a team of seasoned professionals who are constantly reviewing the three legs of the investment stool. We analyze portfolios and securities for changes and update our security ranking system regularly. The four portfolio managers review portfolio construction both from a micro and macro perspective.

Many companies get screened out of our strict investment guidelines. In fact, Wellesley Asset Management owns only about 20% of the names in the convertible universe. In order for an investment to be implemented at Wellesley Asset Management, all three legs of the investment stool must be strong. Our thorough investment process tries to shield investors from potential weak legs of the investment stool, and keep their portfolios on firm footing.

The Traditional 60/40 Portfolio is DEAD

For decades, financial advisors have touted model portfolios built around the idea of a 60/40 portfolio. This generally means a portfolio with 60% in stocks and 40% in bonds. This strategy had worked for investors over the past 40 plus years. Since 1980, it has returned 10.54% annually with a return of 11.97% from the S&P 500 and a return of 7.51% from the Bloomberg Barclays Aggregate Bond Index.

Since the 1970s the bond market has experienced one of the longest bull markets in history. During this time, interest rates declined from the mid-teens to low single digits and even negative rates in many European countries. The way bond math works is that when you invest in high interest rates and they generally decline; the value of your portfolio increases via rising bond prices. Now, with the 10-year Treasury rate at approximately 0.90% and investment grade corporate bonds yielding approximately 1.30%, a portfolio will only garner that return over its lifespan, unless interest rates continue to fall towards 0% or managers are able to reinvest at higher rates. Therefore, many investors in

fixed income have grown accustomed to seeing one of two things: making a nice return on the coupon of the bond or making a return from the coupon and then some as rates drop and the value of their portfolio increases. Fast forward to today, and the choices are widely different, with either low single digit or even negative returns.

From an asset allocation perspective for advisors, this made investing relatively simple. Using a mix of stocks and bonds, whether other asset classes were included or not, allowed investors to receive a solid rate of return. Today's environment is a different animal. Interest rates are nearly 0%, so upside is limited for the 40% of the pie. Stocks, representing the 60% of the pie, are near all-time highs from a valuation perspective as well. This does not mean that stocks cannot continue to generate solid returns, but many institutional investors have estimated long-term return to be below prior decades' returns going forward.

One way to reinvent the 60/40 portfolio is properly managed investments in convertible bonds. As mentioned in these newsletters and previous writings, convertible bonds are a hybrid investment between stocks and bonds. Of note, the popularity of convertible bond issuance increased in 2020 as companies looked for other ways to receive low-cost capital to fund current operations and future growth. For Wellesley investors, this has allowed us to select new companies with high quality balance sheets that have room for future growth. Compared to a 60/40 portfolio, the characteristics of a Wellesley convertible bond portfolio over time have been relatively similar. The performance of a standard 60/40 portfolio since 1995 has been 8.90%, while our Wellesley Investment Advisors (WIA) Composite returned 8.21% (net of fees). Further, the WIA Composite has done this with a lower standard deviation (measure of risk) than the 60/40 portfolio. The WIA Composite had a standard deviation of 8.23% since 1995 compared to the 60/40 portfolio of 9.11%. Of course, this does not even consider the future of investment returns going forward, as noted earlier.

In summary, let us borrow an analogy conceived by Warren Buffett: If we were driving a 3,000-pound car and came upon a bridge certified for 10,000 pounds, we would comfortably cross; if we were driving a 9,900-pound truck, we would seek an alternate route. What we mean by this is that, consider the 60/40 portfolio the 9,900-pound truck, while the bridge is your retirement. We consider using a vehicle with this much weight fairly risky. While we are not engineers at Wellesley Asset Management, we understand risk. We believe a properly managed convertible bond portfolio can successfully navigate the bumps along the road during retirement.

[1] A 60/40 Portfolio is represented by 60% S&P 500 Index TR and 40% Bloomberg Barclay Aggregate Bond Index rebalanced quarterly. You cannot invest directly in an index.

Got the Need for Income in Retirement

Imagine yourself on an island sitting in your perfect beach chair along with a long-awaited cocktail. You feel the sun on your face and you are ready for your new adventure: retirement. This is the feeling that many of us long for as we reach the end of our working careers and look to make the next step. However, retirement can come with a multitude of emotions, feelings and questions. A vital question for soon to be retirees is, "where will my paycheck come from when I am no longer working?" Within this article, we'll address the questions that you may be thinking about and describe how convertible bonds can provide a way for you to enjoy retirement without a worry.

When we consider, taking money out of the proverbial "nest egg," questions arise such as: *Will my money last for my lifetime? What about inflation? Can I continue to enjoy some growth in my assets?* All of these are appropriate questions to consider before retirement. We have a variety of options when withdrawing money from various sources such as a 401(k), traditional defined benefit pension plans, IRAs, brokerage accounts and Social Security. Each comes with its own limitations, benefits, and considerations. For instance, you may know that delaying payments from the Social Security Administration up to age 70 will increase your monthly payment. Therefore, there is no benefit to delay taking social security after age 70. This is simply one example, but with multiple sources to potentially draw from during retirement requires an in-depth conversation with your Wellesley advisor.

A few options from an investment perspective that you may utilize include stocks, bonds, convertible bonds or a combination of investment options. As you may already know from other writings and discussions with your Wellesley advisor, convertible bonds are a hybrid investment between stocks and bonds. Therefore, they act similarly to a combination of stocks and bonds when used within a portfolio.

A benefit that the Wellesley approach has for retirees, or near retirees, is the balanced method and focus on high-quality companies. This has historically provided some protection against pull backs in the equity markets. Now, let's provide a few tangible examples of how to withdraw money during retirement. Expenses for most of us will continue to appear in the form of basic needs such as housing, food, insurance and leisure activities. Each of these will still require money.

The question we then ask ourselves is: How much money will I need during retirement? This is a unique question to each person, but for many during retirement, it follows the form of a "smiley face." This is because, when you initially retire, you look to "check off the boxes" of the things that you have wanted to do when you were working. This may include travelling (in a post-COVID world), buying a vacation home, or eating out more often. Then as we get older, we tend to do less of these things, as we either do not want to do as many of these things or simply want to spend more time at home (the middle part of the smile). Finally, towards the end of the retirement, unfortunately, health care expenses tend to increase requiring further expenses. Of course, as noted above, each person's situation is different.

Turning back to how much money to withdraw from our nest egg each year, a common withdrawal rate is between 4-6%. For simplicity purposes we will use a 5% withdrawal rate, taken out of a $1 million portfolio over the past 20 years.

As you can see, this illustration below depicts how a withdrawal strategy comparing the Wellesley Investment Advisors Composite (Net of Fees) versus a 60% S&P 500 Index / 40% Bloomberg Barclay Aggregate Bond Index portfolio.

We have highlighted select years to simplify the illustration. Over this timeframe, the Wellesley Strategy would have produced a similar outcome in terms of portfolio balance to date, but the amount withdrawn over the 20-year period would have been over $250,000 greater. This is particularly noteworthy when you consider the 5% withdrawal during periods such as 2008. By using WIA, you would have received approximately $16,000 more in 2008 or over $1,000 more per monthly retirement income. The need for retirement income can be a stressful and an emotional topic. With so

Wellesley Investment Advisors Convertible Bond Composite

Year	Return	Annual 5% Withdrawal	Balance
2000	15.31%	57,655	1,095,445
2005	1.81%	59,962	1,139,273
2008	-12.65%	51,000	969,004
2009	34.26%	65,049	1,235,936
2010	11.94%	69,175	1,314,331
2015	-2.48%	64,935	1,233,764
2020 (Through 11/30)	10.27%	66,935	1,271,765
Total Withdrawal		**1,685,190**	
Net Change		**27.18%**	

60% S&P 500 / 40% Bloomberg Barc Agg

Year	Return	Annual 5% Withdrawal	Balance
2000	-0.95%	49,524	940,956
2005	3.80%	44,534	846,154
2008	-20.11%	35,922	682,523
2009	18.27%	40,360	766,833
2010	11.57%	42,777	812,764
2015	0.99%	50,767	964,567
2020 (Through 11/30)	13.35%	65,602	1,246,433
Total Withdrawal		**1,425,573**	
Net Change		**24.64%**	

many investments to choose from, sources to withdraw from and timing issues, we at Wellesley understand your concerns. For questions about your withdrawal strategy, as always please do not hesitate to contact your Wellesley advisor.

The Benefits of 144A Securities

In 1990, the Securities and Exchange Commission introduced Rule 144A as a means for accredited investors to trade securities that were not quoted on an exchange. Since then, adjustments have been made to reduce holding periods and increase liquidity for 144A securities. Today these securities provide many benefits to issuers and investors alike. At Wellesley Asset Management, we provide our investors the opportunity to invest in these securities, even if they aren't accredited investors.

During the 1990s and early 2000s, many companies opted to register their proposed securities offerings with the SEC so that there were no restrictions on who could participate in an offering. For issuers this took time and also cost more money due to the amount of reports that needed to be filed with the SEC prior to an offering. In addition, there was often a roadshow for each new deal where the issuer would meet with potential investors in major U.S. cities. The reporting time combined with the roadshow took several weeks to complete. This led to uncertainty for the issuer and investors over where the security would be trading and what the market conditions would be when the deal was set to price.

The idea of 144A securities came about as a means of reducing both times to market and the amount of information that needed to be provided by an issuer. In order to purchase a 144A security, a buyer has to be a Qualified Institutional Buyer (QIB). A QIB cannot be an individual and must own and invest at least $100 million on a discretionary basis. The idea being that sophisticated investors do not need as much information or time to research new investment ideas. Rule 144A allowed issuers to bring deals to the market on a timelier basis thereby allowing them to take advantage of favorable prices and market conditions.

However, Rule 144A wasn't created without its drawbacks. For one, the initial holding period was two years making the securities very illiquid. In 2008, the SEC relaxed this requirement to six months to a year, depending on the level of reporting a company did. In 2009, 144A securities became TRACE eligible, which meant every transaction had to be posted to a central reporting facility adding transparency to the price discovery process. Today there are no holding requirements on 144A securities and they are as liquid as registered securities.

In addition to providing benefits to issuers, 144A securities can be beneficial to investors. Most new convertible deals come to the market as 144A securities for one of three reasons. Many deals come to market quickly; sometimes on an overnight basis. In addition, new deals are sometimes paired with a stock buyback or the buyback of an existing convertible. Finally, derivatives transactions are sometimes added to convertibles to adjust the conversion price for the issuer of a bond. New deals are beneficial to investors because they are often priced "cheap" so that investors will buy them. According to Barclays, new deals on average were priced 1.35% cheap in 2020. Investors who can buy 144A securities may enjoy what we refer to as the "first day pop" because the securities immediately trade higher on day one.

Many Wellesley Asset Management clients cannot buy 144A securities in their separately managed accounts. Most 144A securities are issued with registration rights, which means after a seasoning period (usually one year) the bonds will become registered and anyone can buy them.

Unfortunately, in rising equity markets like we have experienced over the last 12 years, by the time the bonds become registered, they are too highly priced and are trading at a negative yield to worst, defined as the lowest possible yield that can be received on a bond without the issuer actually defaulting. Fortunately, at Wellesley Asset Management, we allow clients to own our mutual funds (which are QIBs) in their separately managed accounts. This gives them access to 144A names which helps diversify their portfolio and gives them access to new deals which may help improve performance.

Greg, Michael and the Wellesley Asset Management team look forward to another successful year and thank you for your continued trust in our services. We extend our sincerest best wishes to you and your family for good health and happiness as we start this New Year.

NOTES ON THE REFINITIV WELLESLEY CONVERTIBLES INDEX (“RWC0”): The RWC0, which is a hypothetical index, was created to show a convertible bond strategy of buying convertible bonds at or near par value. A direct investment in RWC0 is not possible, just as a direct investment in an index is not possible. Any index performance, including RWC0, does not reflect the deduction of advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid. The RWC0 index performance does not represent performance in any client account, nor is it representative of any actual trading in any client account. Actual client results may be materially less than the index and all hypothetical graph results are approximate. RWC0 has the potential for profit as well as loss.

The Index is a joint venture between Refinitiv and Wellesley Asset Management (WAM) and was created in January 2013. RWC0 index performance from its inception date of January 2000 to 2002 is based on a retroactive selection of convertible bonds from client accounts. Index performance for the period from February 2002 to the creation date is calculated based upon a model portfolio maintained by WAM. Thomson Reuters (now Refinitiv) became the calculation agent for the index in 2013. Wellesley has discretion over the selection of index constituents and does not represent a selection of bonds in any one client account nor is RWC0 representative of performance received in any client account. RWC0’s holdings may differ from the holdings of WAM products. The time periods used in any RWC0 charts is solely representative of examples of historical complete market cycles. A complete market cycle is defined either by top-bottom-top or bottom-top-bottom pattern in the stock market. The S&P 500 is used to define the market.

NOTE ON HYPOTHETICAL PERFORMANCE: There are inherent limitations in using hypothetical performance results and they may not reflect the impact that material economic and market factors might have had on the adviser’s decision-making process if the adviser were actually managing client money. All hypothetical numbers are approximate and may be significantly higher than any client return and such hypothetical numbers are not used as a benchmark for any client’s actual return. Hypothetical growth charts comparing the RWC0 index versus a fixed income and equity index DO NOT represent actual performance any WAM client received. The charts are used for illustrative and educational purposes only and no claim of performance was received by any client.

The information in this presentation is for illustration and discussion purposes only. 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.

Index returns do not reflect the effect of fees or assume reinvestment of all distributions and transaction costs or taxes. A direct investment in an index is not possible.

SHOULD ONLY BE PRESENTED TO SOPHISTICATED CLIENTS OR WITH OTHER INVESTMENT PROFESSIONALS

Footnotes Pertaining to All Years Shown

Past performance is not indicative of future results, Wellesley Investment Advisors, Inc. (“WIA”) is a subsidiary of Wellesley Asset Management, Inc. (“WAM”).

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 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 2020 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.

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 Bloomberg Barclays US Aggregate Bond Index measures the performance of the U.S. investment grade bond market. The index invests in a wide spectrum of public, investment-grade, taxable and fixed income securities in the United States – including government, corporate, and international dollar-denominated bonds, as well as mortgage-backed and asset-backed securities, all with maturities of more than 1 year.

ICE BofA All Yield Alternatives US Convertibles Index (VYLD) is a subset of the ICE BofA US Convertible Index and includes convertible securities with a delta less than 0.4. Delta is the measure of the change in a convertible bond's price given a change in the underlying stock. The inception of this index is 12/31/1998.

Prior to 2022, the composite was also compared against the S&P 500 TR Index as a general market indicator.

Footnotes Pertaining to WIA Performance from 1995 to 2009

WIA performance from its inception date of January 1995 to 2009 is based on a retroactive selection of convertible bonds from client accounts. Index performance for the period from 1995 to 2009, the creation date, is calculated based upon a model portfolio maintained by WAM.

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 WIA's client accounts. Returns do not reflect transaction costs. 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.

NOTE ON HYPOTHETICAL PERFORMANCE: There are inherent limitations in using hypothetical performance results and they may not reflect the impact that material economic and market factors might have had on the adviser's decision-making process if the adviser were actually managing client money. All hypothetical numbers are approximate and may be significantly higher than any client return and such hypothetical numbers are not used as a benchmark for any client's actual return nor are any actual client 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 strategy for the first full month under management and are removed from the strategy 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 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.

Past performance is no guarantee of future results.

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. No content in this newsletter 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. No representation is made that the investor will obtain similar results to those discussed. These articles are meant for broad discussion purposes only, and are not intended as a recommendation to buy or sell any security. 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.

Pertaining to Why Wellesley's Convertible Bond Strategy Now:

Source: https://realinvestmentadvice.com/corporate-profits-are-worse-than-you-think/