Wellesley Asset Management
Summer 2020 Publication

Convertible Bonds: The Advantages of Synthetics

Greg Miller CPA, Founder, Chairman and CEO
Michael Miller, President and CIO
Jim Buckham CFA, Portfolio Manager
Dennis Scarpa CFA, Senior Analyst

Wellesley Asset Management
Convertible Bond Specialists

What Are Synthetic Convertibles?

As a convertible manager for almost 30 years, we view convertible bonds as the best of both worlds for investors: equity participation should a stock appreciate, and the potential downside protection of a bond backed by the credit of the issuing company. One type of convertible bond that you may be unaware of is called a synthetic convertible bond ("synthetic"). Synthetics offer a different take on this hybrid product by potentially adding more protection and differentiation to the asset class. Unlike traditional convertible bonds, the credit exposure of a synthetic remains with the issuing company, typically a bank. The equity exposure, however, is tied to the underlying company's stock.

To illustrate how this construction could add more protection for investors, it's important to look at convertible returns in up and down markets. As a company's stock appreciates significantly, the company's credit usually improves with its stronger financial position. However, the bond's sensitivity to credit improvements diminishes in this scenario. When a company's stock falls significantly, the company's credit deteriorates. Unfortunately, as the stock falls, the bond's sensitivity to changes in credit increases. In other words, just when an investor needs the potential downside protection of the bond, its value decreases. Synthetic convertibles address this asymmetric credit sensitivity by bifurcating credit and equity risk. Credit risk in a synthetic is held via the issuing entity and the equity risk is to the underlying stock. Provided that the issuing entity is a good credit, a synthetic has the ability to hold its value, even if the stock falls.

Synthetics are usually created by pairing a financial institution's credit with exposure to an unrelated equity chosen by the investor. The financial institution issues a bond and sells an option on the desired equity exposure. However, the issuing entity need not be a financial institution. Any entity looking to raise capital can issue synthetic convertibles. This can include corporate, sovereign and government entities such as the World Bank. Additionally, investors can create their own synthetics by pairing a U.S. Treasury Bond with an equity call option.

Exchangeable Bonds

Another flavor of convertible bonds that look similar to synthetics are exchangeable bonds. In the case of exchangeable convertible bonds, the equity exposure is chosen by a financial entity or a company, rather than the investor. For example, three large banks recently issued exchangeable bonds on Voya Financial, a company focusing on retirement administration and finance. The banks had bid for, and won, Voya warrants (long-dated options) which ING owned. Each bank combined the warrants with newly issued bonds to create exchangeable convertible bonds. The issuing entity can also be another company. Liberty Media, for example, has been on an acquisition spree for years. Sometimes the company will create a stock to track the performance of an acquisition. Liberty Media has issued several exchangeable convertible bonds where the equity exposure is to a tracking stock of an acquired business.

Another difference between these two securities is that synthetic convertibles tend to be bespoke securities made for one buyer while exchangeable convertibles usually have several institutional buyers. Typically, therefore, exchangeable convertible issues tend to be larger and have more active secondary markets.

How Are Synthetic Convertibles Used in Portfolio Construction?

At Wellesley Asset Management ("Wellesley"/"WAM"), synthetic convertible bonds are an integral part of our portfolios for several reasons. Since we typically invest in short to middle duration bonds, new bonds are needed to replace bonds that are maturing, getting called, or are downgraded due to declining fundamentals. Oftentimes, newly issued bonds don't meet our strict investing guidelines.

In volatile times like these, we use more synthetic convertibles to supply new bonds that meet our criteria. Furthermore, we like to use synthetic convertible bonds to express our best stock and trading ideas. Some of the companies we really like are companies who, for various reasons, rarely issue debt in the convertible market. Synthetic convertibles give us an opportunity to invest in these companies. Also, traditional convertible bond issuance can at times be too skewed to specific sectors or market capitalizations. We use synthetic convertibles to provide greater diversification in our portfolios across sectors and market capitalizations. And finally, since synthetic convertibles are custom made, we can work with the issuer to determine the various parameters for each bond ensuring that we get the best possible terms.

Advantages of Synthetic Convertibles

There are numerous advantages to synthetic convertibles over other bonds. First, the credit quality is typically investment grade since the notes are written by banks that back the par value; therefore, the credit quality is based on the bank. This compares to most convertible bonds that are either non-investment grade or not rated. We frequently review our bank exposure and limit bank concentration risk.

Synthetic Convertibles: Advantages/Disadvantages

Advantages of Synthetics:

1. **Liquidity:** Synthetic issuers maintain liquid 1% bid/ask daily markets.
2. **High Credit Quality:** Credit rating is based on issuer. WAM only partners with investment grade issuers. Most synthetic notes have higher credit ratings than traditional convertible or straight debt.
3. **Large Cap Company Exposure:** Allows exposure to top large cap companies that generally do not issue convertibles during periods of low interest rates.
4. **Outperformance:** Historically, synthetic convertibles have outperformed other convertible instruments in bear markets.
5. **Lower Premium:** Many synthetics have lower premiums compared to straight convertibles, giving more of the upside participation in the underlying stock.
6. **Choosing Issuers:** WAM generally limits exposure to any one financial institution to less than 8% upon acquisition. Credit quality is monitored regularly on all financial institutions that issue synthetics.
7. **Growth with Less Credit Risk:** Synthetics can provide exposure to companies with high growth rates and low PEG ratios but weaker balance sheets, since return of principal is promised, barring default, by an investment grade financial institution.

Disadvantage of Synthetics:

1. **Tax Treatment:** Tax treatment may be less favorable than a regular convertible bond taxable account.

The above list is not intended to represent all the advantages and disadvantages of synthetic convertible bonds.

As mentioned briefly, synthetics allow for portfolio diversification through better capitalization and sector exposure. Given the current low interest rate environment, few large cap companies have issued convertibles. However, through buying synthetics in large-cap companies, we are able to avoid an unintended overweighting to small-cap companies.

In bear markets, synthetic convertibles tend to outperform convertibles because of the bifurcation of equity and credit risk. For example, in 2006, we bought a synthetic issued by Eksportfinans A/S (A Norwegian Government Agency) convertible into United Parcel Service (UPS). In October of 2008, during the bear market, we sold this security for only a 1.2% loss while UPS stock fell over 40% during that period. Furthermore, the value of the convertibles market in general fell over 28%. The UPS synthetic held its value because of the credit quality of Eksportfinans A/S.

In general, liquidity, in terms of size and price, tends to be better with synthetics. When reviewing synthetic counterparties, we look at the bank's ability to provide a liquid secondary market. Banks are expected to provide updated markets throughout the day with competitive bid/ask spreads. In addition, the prices are usually good for larger amounts than we can normally transact in ordinary trading.

Another benefit of synthetics is the opportunity to invest in companies with high earnings growth rates and low PEG ratios*, but weaker balance sheets. (*The PEG ratio is a valuation metric for determining the relative trade-off between the price of a stock, the earnings generated per share, and the company's expected growth. In general, the PEG ratio is higher for a company with a higher growth rate.) One example is the Bank of America .125% 9/1/22 exchangeable in Charter Communications. Charter's earnings growth rate over the next three years is over 50% and the stock's PEG ratio is a little over 1, but the balance sheet is overly levered resulting in Charter's junk credit rating. Pairing a high growth stock with an investment grade credit can provide investors with an attractive risk/reward profile.

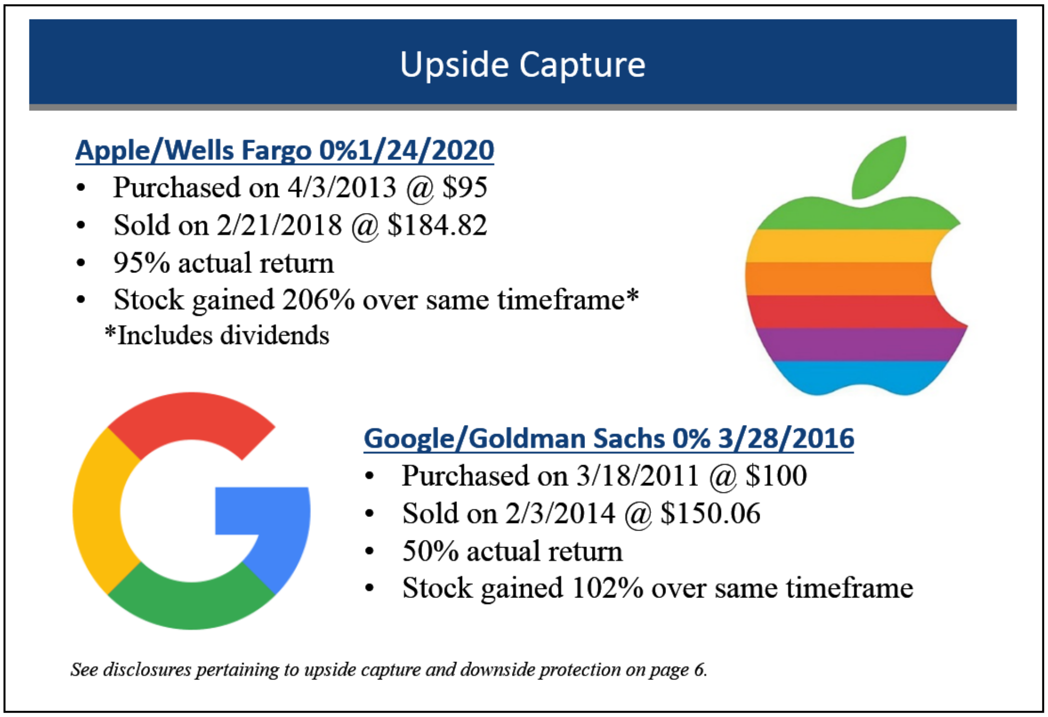
Lastly, we can suggest companies to synthetic issuers from our best research ideas. This means after we formally make a suggestion on a given name, we receive quotes from various banks and financial institutions and select the issuer who provides the most attractive profile for clients, giving us optionality with not only the selection of the underlying company but also the terms of the deal.

It is important to point out one drawback to synthetic convertibles is the tax treatment of gains for taxable accounts. Under IRS guidelines, any gains in taxable accounts on synthetic convertibles are taxed as ordinary income instead of capital gains. When possible, WAM tries to place synthetic convertibles in IRA and other non-taxable accounts. That being said, Wellesley believes the ability to eliminate or minimize losses on securities greatly outweighs the difference in the taxes for all investors, regardless of their tax situation.

Risk/Return Profile

As mentioned previously, one of the key features of synthetics is the potential for a highly favorable up/down market capture. Such potential provides investors with a very attractive return profile having less upside potential than the stock, but also less downside risk. We are able to produce this profile via active portfolio management. Our investment team focuses on a list of companies by using the same metrics that we look for in our convertible analysis except with a larger focus on the income statement. Since the bond will be issued by an investment grade bank or financial institution and backed by their own credit, the risk of the note defaulting is not correlated to the credit of the company itself. Again, this is an advantage of synthetics where the credit rating is based on the issuer of the synthetic, not the company who the issuer created the synthetic for.

The companies we focus on are in underrepresented sectors within the convertible market (such as Apple and Google in the chart below). As previously discussed, the convertibles market lacks many larger cap company issuers and is concentrated in mostly small/mid-cap technology, financials and



healthcare companies. For example, within the last six months, we have bought two synthetics on Exxon Mobil while the convertible market has limited large-cap energy exposure (less than 3% allocation). By using synthetics, we are able to obtain a position in one of the strongest names in their respective industry.

Of course, with all active management there are both winning and losing hands. However, one of the truly appreciated advantages of synthetics is the potential downside protection that it offers (refer to the Downside Protection chart on page 5). For instance, we purchased a General Electric synthetic in 2014 with a seven-year maturity, 0% coupon, maturing in 2021. We ultimately sold the bond at a loss in 2018 resulting in an average decline of approximately 10.9%. Of course, a loss is never encouraging, but during the same time GE stock fell a whopping 43% (including dividends)! For an equity investor, losing 43% over a four-year period during a bull market is an extreme loss; but by holding the synthetic, we were able to avoid GE's credit issues and capture only 25% of GE's stock's downslide.

On the other hand, we have had many examples of strong upmarket capture over the past 20 years. For example, in 2013 we invested in an Apple synthetic with Wells Fargo holding the bond for five years, selling it in 2018 for $184.82 – netting a 95% gain. At the same time, the Apple stock soared over 206% (including dividends). While the bond did not keep up with the stock, we were pleased with a 95% return on the position for clients.

Downside Protection

UPS/DB 2% 4/18/2012

- Purchased on 4/11/2006 @ $100
- Sold on 10/27/2008 @ $93.75
- -1.2% actual loss*
- Stock lost -42% over same timeframe*

*Includes dividends and interest income

GE/Barclay's 0% 8/18/2021

- Purchased on 8/11/2014 @ $100
- Sold on 9/17/2018 @ $89.13
- -10.9% actual loss
- Stock lost -43% over same timeframe*

*Includes dividends

See disclosures pertaining to upside capture and downside protection on page 6.

As a convertible bond manager, we are happy that our investable universe is not entirely determined by traditional convertible issuance. For over 20 years, we have used synthetic convertibles and exchangeables effectively in our clients' portfolios allowing us to diversify portfolios, add liquidity, and gain access to securities we otherwise would not have. This profile has been very attractive, particularly now when we can bring added value to our clients.

Disclosures

Past performance is no guarantee 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 information presented herein has been developed internally and/or obtained from sources believed to be reliable; however, Wellesley Asset Management does not guarantee the accuracy, adequacy, or completeness of such information.

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 result in lower returns to taxable investors.

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

Convertible bonds, like all fixed income securities, are subject to increased loss of principal during periods of rising interest rates and are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Lower-rated securities are subject to greater credit risk, default risk, and liquidity risk. Convertible bonds will fluctuate in value with the price changes of the company's underlying stock. Before purchasing convertible bonds, investors should carefully review the bond prospectus and consult with a financial advisor who has experience in investing in and trading convertible bonds. Individual convertible bonds should be purchased based on risk tolerance, time horizons and other factors in concert with an investment professional.

Disclosures Pertaining to Upside Capture and Downside Protection Charts

These examples are for educational purposes only and are intended to illustrate scenarios where a synthetic bond was limited in the participation of a stock's upside or downside. These examples do not reflect WAM's actual performance during the period these securities were held. The specific securities identified and described in these examples do not represent all of the securities purchased, sold, or recommended for advisory clients. Returns were calculated based on the first day the security was purchased and the last day it was sold. An investor's actual performance may differ from the performance presented due to timing of investment, contributions and withdrawals. No representation is made that the investor will obtain similar results to those shown. A complete list of securities recommended by the firm during the past year is available upon request. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities in the examples. All numbers are approximate.

Wellesley Asset Management, Inc.
20 William Street, Wellesley, MA 02481
781-416-4000 Fax: 781-237-6163
www.WellesleyAssetManagement.com