A Genius, an Investment Guru, and a Golfer Walk into a Par

Take a look at the two investments below. Which would you prefer? The simple average of returns in Investment A would be 10% (29+20-30+21=40/4=10). The simple average of returns in Investment B would be 10% (19+11-4+14=40/4=10). Unfortunately, simple averaging does not paint a clear picture nor is it appropriate to use with market returns. Annualized averaging is a far more accurate gauge due to the concept of compounding.

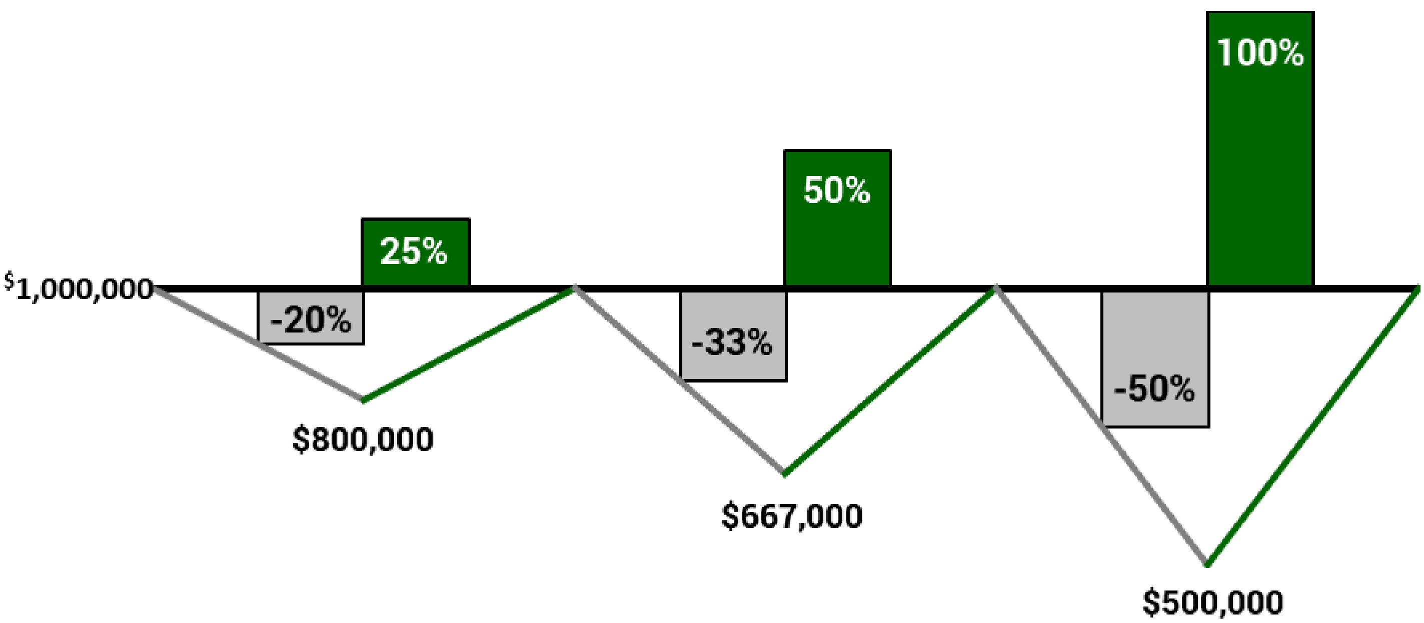
	Investment A	Investment B
Starting Value	**$1,000,000**	**$1,000,000**
Year 1 Return	**29%**	**19%**
Year 2 Return	**20%**	**11%**
Year 3 Return	**-30%**	**-4%**
Year 4 Return	**21%**	**14%**

Now, let's take a look at the annualized and cumulative returns below for the same investments. Investment A significantly underperformed Investment B. The negative return in Year 3 diminishes the overall returns in Investment A. This highlights the importance of managing drawdown, or the peak-to-trough decline, of an investment. It is crucial, especially when the market is near an all-time high, to seek downside protection to reduce the magnitude of potential losses. The overconfidence experienced by many investors near the height of a bull market lends to their forgetfulness of lessons learned from the great recession and depression to the dot-com and tulip mania bubbles.

	Investment A	Investment B
Starting Value	**$1,000,000**	**$1,000,000**
Year 1 Return	**29%**	**19%**
Year 1 End Value	**$1,290,000**	**$1,190,000**
Year 2 Return	**20%**	**11%**
Year 2 End Value	**$1,548,000**	**$1,320,900**
Year 3 Return	**-30%**	**-4%**
Year 3 End Value	**$1,083,600**	**$1,268,064**
Year 4 Return	**21%**	**14%**
Year 4 End Value	**$1,311,156**	**$1,445,593**
Annualized Return	**7.01%**	**9.65%**
Cumulative Return	**31.12%**	**44.56%**

"Par" is the expected number of strokes it should take an expert golfer to complete a hole. "Birdie" means a score of 1-under par on any individual golf hole. A game of golf is rarely won by having the best score on a single hole; there were many holes before and after that contributed to the victory. The same applies to investing; rarely does one year of great returns ensure long-term financial success. It is important to invest with a time horizon over a complete market cycle which encompasses both a bull and bear market.

As shown below, if an investment falls by 20% ($1M to $800K), to get back to par, the investment will have to go up by 25% ($800K to $1M); if the investment declines by 33.3% ($1M to $667K), a gain of 50% would be required to break-even ($667K to $1M); lose 50% ($1M to $500K), and the investment will need to double or increase by 100% ($500K to $1M) just to recover from the drawdown. From a percentage standpoint, your investment would need to work harder on the way up to offset the losses suffered on the way down.

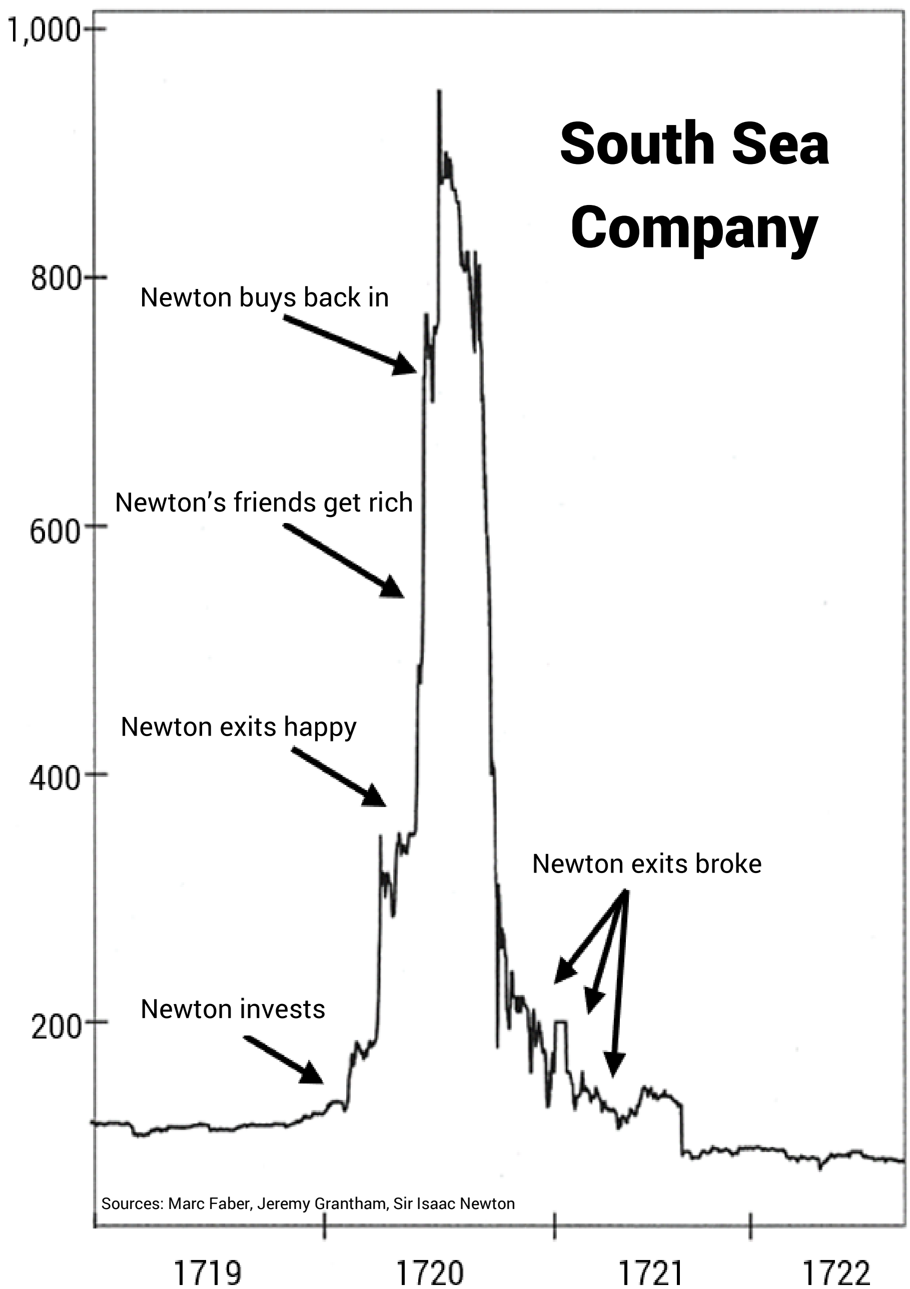


The cost of losing money on the downside is disproportionate to making money on the upside. Therefore, a vital component to wealth accumulation and preservation is protecting against large losses. So, while admiring the view from atop the stock market skyscraper, remember that equities may take an escalator up, but also may take an elevator down.

> **"WHAT GOES UP MUST COME DOWN"**
>
> **– Sir Isaac Newton**

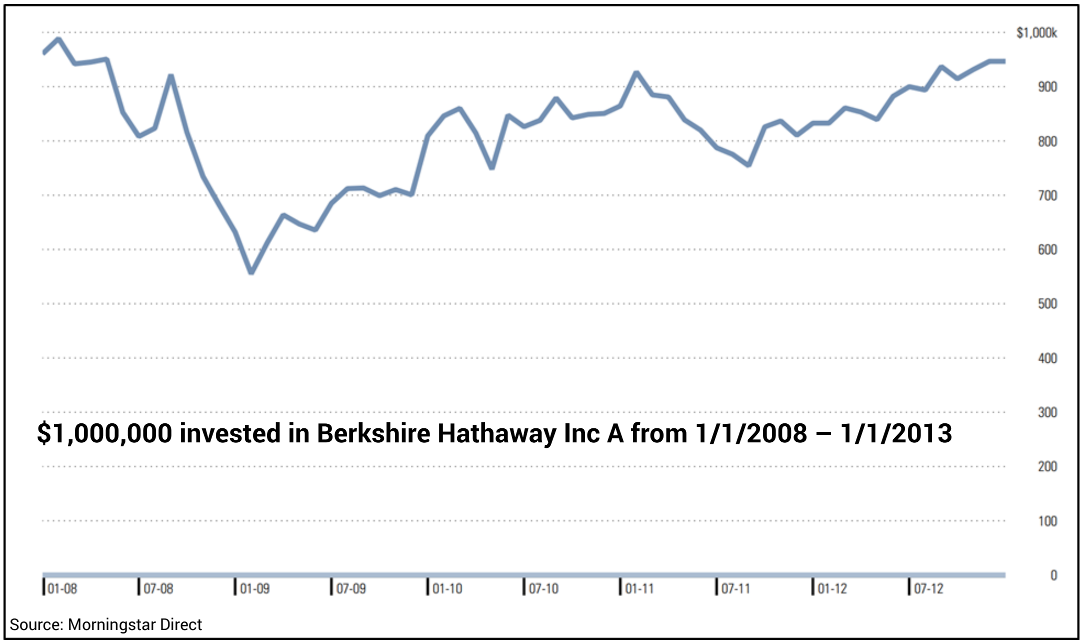
In early 1720, Sir Isaac Newton purchased shares in the South Sea Company. Newton's shares quickly soared and doubled in value. He decided to sell and profited, what today would be over $1 million. After selling, the shares continued to soar and Newton watched as his friends got rich. Rather than being happy with doubling his money in such a short amount of time, Newton compared his financial success relative to that of his friends. Newton bought back in - at a much higher price - only to sell at a loss, of what today would be $3 million.

Many investment strategies seek to produce returns that are better than a chosen benchmark such as a market index (or in Newton's case, his peers). This type of management is referred to as a relative return approach to investing and uses relative returns to gauge its success. Meaning, if the benchmark were to fall by 50% and the investment were to decline by 49%, it would be considered a win.

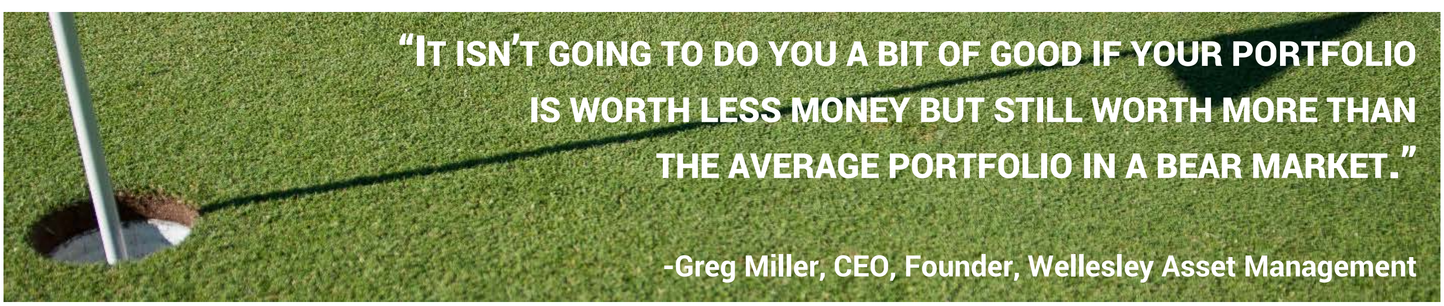


> **"TO INVEST SUCCESSFULLY DOES NOT REQUIRE A STRATOSPHERIC IQ... WHAT'S NEEDED IS A SOUND INTELLECTUAL FRAMEWORK FOR MAKING DECISIONS AND THE ABILITY TO KEEP EMOTIONS FROM CORRODING THE FRAMEWORK."**
>
> **– Warren Buffett**

Warren Buffett's rules are easier said than done. Berkshire Hathaway has had periods where the stock fell and had not recovered after five years.



Absolute return differs from relative return as it does not compare an investment's return to a benchmark or any other measure. Producing positive returns is the main objective of an absolute return strategy. Though investment gains can never be guaranteed, an absolute return strategy seeks to make positive returns by employing investment management techniques that differ from traditional strategies concerned with relative returns. An absolute return strategy seeks to win by not losing.



A balanced convertible bond strategy seeking absolute return can be achieved in a number of ways. For example; investing in bonds issued by companies with high-quality balance sheets, purchased near their par value, and with a properly structured maturity schedule. The market price of a bond may fluctuate above or below par, depending on factors including the price of the underlying stock, the level of interest rates, credit spreads, and the bond's credit status.

One of the key features of a bond is its par value. The par value is the dollar amount - typically $1,000 - that bond issuers promise to repay investors on the maturity date of the bond. In the case of a convertible bond, if the underlying stock were to increase to a prespecified value, the convertible bond would capture some of the upside, and subsequently increase in value as well.

If the underlying stock were to decrease in value the convertible bondholder would expect to receive the semi-annual coupon income, and at maturity, the par value of the bond (barring default). In a bear market, par for the course (that which is to be expected under the given circumstances) would be that the investor gets their money back on the maturity date, plus interest.

Sam Snead, who won a record 82 PGA Tour events, once said "Forget your opponents; always play against par". We believe that the same advice can be applied to investing, "forget the indices, always play against par". Since 1991, when Wellesley Asset Management was founded, our strategy has been centered around one core goal: protection of principal. We do not get greedy in bull markets and we do not panic in bear markets. We have found that by investing in short duration convertible bonds of high-quality companies, we have been able to consistently outperform both stocks and bonds over full market cycles.

Important Disclosures:

All investments, including convertible bonds, have a risk of loss.

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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.

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