The Convertible Investor

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

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IN THIS ISSUE ...

Sweet Spot Investing with Convertible Bonds

Convertible bonds are sometimes considered the "Swiss Army knife" of financial products because they can provide investors with principal protection (barring default), income, and equity-like returns. The combination of a corporate bond with a call option can provide investors with asymmetrical returns: when stocks rise, the returns are more equity-like; when stocks fall, the returns are more bond-like. A convertible bond′s value is the potential to increase returns in a fixed income portfolio and dampen volatility in an equity portfolio. ***The secret to enjoying these benefits is investing in what convertible bond managers refer to as the*** "***sweet spot.***" This means investing in convertible bonds trading close to par that have a balanced profile. Here at Wellesley Asset Management, we look to invest in the sweet spot of convertible bonds to unlock the many benefits this financial instrument can provide to investors.

Options traders use the term "delta" to describe the change in price of an option in relation to the change in price of the underlying security. For example, if a call option in

(Continued on Page 2)

Apple, Inc. is trading on a 50 delta (the delta is the ratio of the change in price of an option to the change in price of the underlying asset) and Apple stock moves favorably by $1.00, then the option′s value will increase by $.50. Similarly, the convertible market uses delta to compare changes in stock prices to changes in convertible bond prices. Balanced convertible bonds typically have deltas ranging from 45 to 65 while "in-the-money" convertibles typically have deltas higher than 70. "Out-of-the money" convertibles have deltas below 40. Where convertible bonds are trading on the delta continuum has a big impact on their risk/return profiles.

As a stock moves higher, the company′s convertible bond price and delta move higher. The further the convertible bond moves above par value, the lower the yield to maturity and current yield. In other words, the bond is gaining more equity sensitivity and losing its bond characteristics. This bond profile is not without its risks. Consider a bond trading at 115 compared to a bond trading at 180. Knowing that the bond-like protective features are not realized until the convertible trades close to 100, it is easy to see that the bond trading at 180 has more downside equity risk. One could make an analogy to insurance policies where the bond trading at 180 is like a high deductible policy. That is, investor insurance isn't realized until the investor suffers a large loss. In this example, an investor suffers about a 44% loss before getting any "insurance" benefit. However, the premium the investor pays for the insurance is not large (in the case of the convertible bond, this translates to greater equity upside).

A bond trading at 115 is more like a low deductible insurance policy. Here, the investor doesn't have to endure a great loss before they approach par value. In this example, the investor suffers only a 13% loss before getting an "insurance" benefit. However, the insurance policy costs more in the form of lower equity upside for the investor.

The opposite holds true when a stock moves lower. The convertible bond′s price and delta move lower while the yield to maturity and current yield move higher making the convertible less equity sensitive and more bond like. However, this profile is not without its drawbacks as the stock price can move so far that the convertible′s embedded option becomes worthless. These bonds are often referred to as "busted" because the stock has very little chance of reaching the conversion price (strike price of the call option) before the bond matures. Another concern for lower priced convertibles is they are more sensitive to credit metrics and interest rates. Unfavorable changes in a company′s balance sheet or interest rates can have a larger impact on a lower priced convertible.

This brings us to the sweet spot of convertible investing – *balanced convertibles*.

Balanced convertibles trade around 90 to 110 and have a little bit of something for everyone. For equity investors seeking capital appreciation, these bonds usually trade with deltas ranging from 45 to 65. For income investors, these bonds usually have positive yields to maturity. And for investors concerned about risk, these bonds trade close to 100 which means they are close to the bond-like protective features of a convertible bond.

At Wellesley Asset Management we manage our portfolio risks so that the average bond profile is in the sweet spot. We typically buy bonds that are trading at a positive yield to maturity, guaranteeing the return of principal (barring a default). Many convertible managers buy deeply appreciated securities with double digit negative yields to maturity. In this scenario, if the stock falls significantly, the investor could realize more than 10% annual losses for the life of the convertible. We rarely establish new positions in bonds trading significantly below par for risk of exposing our investors to negative credit events and unfavorable moves in interest rates.

Though we may hold 60 to 80 positions in our mutual funds, we manage the portfolio risk on a global basis. Each day we look at the average bond price and yield to maturity in our funds. The average bond price typically ranges from 95 to 110. Once it approaches 110, we typically look to sell some deeply appreciated securities to bring the average bond price lower. Additionally, we monitor the yield to maturity with the aim of keeping it positive. When the yield to maturity approaches zero, we typically sell off highly appreciated securities in an effort to keep it positive. By taking these steps, we target our investors to stay in the sweet spot of convertible investing.

Given the recent volatility we have seen in the markets, including a full market cycle in less than two months, we think the time is right to be investing in convertible bonds. ***But how you invest in convertibles is equally as important as your decision to invest in convertibles.*** Investing in a strategy that has a high average bond price and a high delta will leave you exposed to downturns in the equity market. Conversely, investing in a low price, low delta strategy could leave you vulnerable to credit events, unfavorable moves in interest rates, and little exposure to possible equity upside.

Wellesley Asset Management has been investing in convertible bonds for nearly 30 years. We initially fell in love with the potential safety and optionality the product can offer to investors. We remain focused on buying bonds in the sweet spot as we believe that a portfolio of balanced convertible bonds can provide investors with attractive asymmetric returns.

Record Issuance in the Convertible Bond Market

On March 23, 2020, the Federal Government announced a massive stimulus plan called the CARES Act to keep the U.S. economy working while the world dealt with the COVID-19 pandemic. Having already lowered the Federal Funds Rate to 1% on March 13th, the Federal Reserve announced plans to buy U.S. Treasuries and corporate debt across a broad range of credit ratings including junk. In simple terms, this means that the Fed has become the buyer of last resort and will backstop the debt markets if more trouble arises. This coupled with the high levels of volatility in the equity markets and rising stock prices provided the perfect backdrop for convertible bond issuance. Now at the halfway point of the year, the convertible bond market has already set a record for new issuance and the market is showing no signs of slowing down.

The month of May set a new record for convertible issuance with over $21 billion coming to the market! April was also a solid month with $13 billion of convertible issuance. June is also looking stout as $13.9 billion of new convertible bonds were issued making it the tenth largest month on record. This year′s total issuance of $58B has already surpassed all of last year′s new issuance and represents a 160% increase year over year.

Many experts look at organic or net growth as a means of judging the health of a market. This methodology subtracts any redemptions defined as puts, calls, maturities, buybacks, and exchanges from new bonds issued in the market. Over the last four years redemptions have been averaging between $40 and $45 billion a year. This year redemptions are expected to be in a much lower range of $20 to $30 billion. The combination of strong new issuance and lower redemptions should help the convertible market grow significantly this year. Assuming new issuance continues at its frenetic pace and redemptions come in as anticipated, the U.S. convertible market could end the year with a face value around $315 billion. This would be significant considering the convertible market peaked in 2008 with a face value of $348 billion.

The convertible market has been dominated by three sectors in the past five years: technology, healthcare, and financials. While technology and healthcare continue to be strong sectors for new issuance, consumer discretionary companies have played a larger role year to date. Airlines, cruise lines, and retail stores have represented a reasonable amount of the new deal activity this year. As a convertible bond manager, the obvious benefit to increased new issuance is having more bonds available to select from when building client portfolios. A secondary benefit can also be the increase in issuance within sectors that have been traditionally underrepresented in the convertible market.

Having managed convertible bonds for nearly 30 years, we are significant advocates of the asset class. Unlike other asset classes, convertibles provide versatility which can increase returns and reduce risk within portfolios. However, the capital markets have not always loved convertible bonds and issuance rates ebb and flow. We are hopeful the combination of new issuance and lower redemptions bodes well for a healthy convertible market that continues to grow and be recognized as a valuable tool within an investor′s portfolio.

Buyers Beware of Your Index

The so called "FANG" trade has not lost its luster for investors. For those who are not familiar with the FANG stocks, they are Facebook, Amazon, Netflix and Google (Alphabet). The trade has been relatively simple over the last ten-plus years – invest in these companies and you have done well. However, the question for today′s investors, is not what has happened in the past, but what is going to happen in the future. The global pandemic has created uncertainty and some are concerned about these companies′ stability. In many prior downturns, markets have shifted toward more value-type names, such as companies with high dividends, strong balance sheets and resilient business models. On the other hand, technology is clearly a part of our future. Most employees remain working from home, using video conferencing software, VPNs, and other tools. Additionally, people have more leisure time and companies such as Facebook have capitalized, seeing an of 11% year over year growth in daily active users. So what does all this mean for investors and why is this article called "Buyers Beware of Your Index"? We′ll review what has happened so far in 2020 and our viewpoints on where we go from here.

2020 has been a year that most did not see coming. As investors, we pride ourselves in attempting to understand how various scenarios may play out, but COVID-19 has been a different animal. From an investment perspective, we have seen an acceleration of trends already underway. For instance, when speaking to other investors, CEOs, CFOs and business leaders, one common theme is that working remotely has actually worked out well for many businesses. Many have taken this opportunity to allow employees the option to work remotely at least until the end of the summer, if not into 2021. Technology companies have benefited from this trend as seen by their continued concentration within stock market indexes.

Two common large cap indexes, the S&P 500 and the NASDAQ have had incredibly different returns in 2020. As of June 30, 2020, the S&P 500 was down -3.09%, while the NASDAQ was up 12.74%. This is a disparity we have not seen since the dot-com bubble in 1999. The stocks that have driven this difference are the FANG and what is now deemed FANG+, FANG stocks plus Apple, Twitter, Tesla, Nvidia, Alibaba, and Baidu. Just these four companies, Apple, Amazon, Facebook and Google, are up over 25.6% on average in 2020. These big companies have been compared to chicken noodle soup by advisers at times; meaning you don′t lose clients for adding more money to them.

As mentioned previously, while there are tailwinds driving these companies higher, many issues can surface rather quickly. For example, if the economy does not recover as quickly as anticipated, will customers continue to flock to Apple for their higher priced products? This is the type of question that we are asking and debating over ourselves, and why we prefer to use synthetic issues as convertible bond alternatives for these companies. Other companies, such as Tesla, the high-flying self-driving car company have done very well this year. The company has been among the largest issuers of convertible bonds – in our view, a company with lots of potential but no profits until recently and huge unsustainable debt loads. This one company is up over 139% year to date.

In terms of our strategy and next steps moving forward, we continue to like some of these technology companies, but again within a synthetic convertible note. For more information on synthetic convertible bonds, we have a recent article discussing their advantages posted on our website, wam.com.

We continue to look for new balanced profile convertibles that seek to protect investors in a downturn. This means avoiding companies with unwieldy balance sheets and that are not profitable. While this may negatively impact our returns in environments like this year, over full market cycles, when various types of companies do well, our returns have historically shined.

The History of Convertible Bonds

The history of convertible bonds in America began with a bond issued by the Rome, Watertown, and Ogdensburg Railroad in 1874. Since then there have been many innovations in the convertible asset class. These innovations have allowed

for better outcomes for both convertible issuers and investors. The versatility of convertibles has contributed to its longevity as one of the oldest financial asset classes in America. Looking at its 145-plus year history, many changes have led to today′s convertible market as we know it.

Did you know that the rapid growth of the American railway system was financed, in large part, by convertible bonds? After the first convertible issue in 1874, many other railroads followed with their own convertible issues. In the late 1800s and early 1900s, other fast-growing industries such as steel, utilities, distilleries and steam engine producers used financing through convertibles to facilitate growth. Throughout the 1920s and 1930s many blue chip companies such as GE, Westinghouse, and Western Union issued convertibles. Even though their stocks declined significantly during the Great Depression, convertible investors received par value for their bonds at maturity (return of principal).

As the post-war economy of the 1950s and 1960s boomed, growth by acquisitions became a very popular business strategy. In order to finance this growth, many companies issued convertible bonds to raise the additional capital needed. However, one key concern for investors in the 1970s was companies redeeming (or calling) their bonds early. In one instance, a company′s stock appreciated so quickly that its convertible bond was called before the first coupon payment, angering its investors. The convertible issuer of the time responded to investors′ concerns. Thus, the first call protection (known as "hard call protection") was created giving investors a grace period before a company could call its bonds. This provided the certainty that we believe is critical for our investors today.

In 1982, a further enhancement to the convertible bond marketplace was added, called "soft call protection." Under this provision, a company could not call its convertible bonds unless certain criteria were met. Typically, this involved the underlying stock trading above a percentage of the conversion price for a number of consecutive days (e.g. the stock must trade to 140% of the conversion price for 30 consecutive days). In addition to calls, another important feature was added to convertible bonds in the 1980s: the put. Put provisions gave investors the ability to sell (or put) their bonds back to the issuing company at set dates throughout the life of the bond. This change is crucial for investors, allowing them the flexibility to change their minds on a security if circumstances change.

Further innovation in the convertible market continued in the 2000s. Contingent convertibles were the next feature to be added to the asset class. On a basic level, this allowed issuers to avoid the potential dilutive nature of the bond. While traditionally, the potential shares created by a convertible had to be included in a company′s share count, contingent convertibles only become convertible when a second threshold (other than the strike price) was met. Companies did not have to count the potential shares in their share count because of this second threshold. The lower share count allowed companies to report higher earnings per share.

The next growth in the convertible market took place in the mid-2000s when dividend protection was added for investors. In 2003, Mandalay Bay Resort and Casino issued a convertible bond. At the time, corporate insiders such as the CEO, CFO, etc., were large holders of the stock. Company officials decided to reward equity investors with a large dividend payout. Unfortunately, because dividend protection was not a part of the convertible bond, this payout caused a negative event for investors in these securities. When a stock goes ex-dividend, its value decreases by the amount of the dividend. Following this situation, investors in convertible bonds called for a dividend protection in order to avoid another situation like this. Under the provision, when a dividend is raised, the conversion ratio of the convertible bond is increased to neutralize the impact of the higher dividend.

A second event happened with the Mandalay Bay bond that hurt convertible investors. In 2005, Mandalay Bay was bought by MGM Resorts in an all-cash deal. Since Mandalay Bay was purchased with cash, the stock, and therefore the convertible bond no longer existed. Convertible bondholders received the higher of parity (equity price times the conversion ratio) or par. Unfortunately, bondholders lost all remaining coupon income and option value left on the convertible bond. To compensate investors for this, a "make whole" table was created and is now included in most convertible structures. The table compensates convertible investors by giving them additional shares which are added to the conversion ratio. This provides protection that most convertible investors agree is crucial in today′s environment.

Convertible bonds represent one of the oldest asset classes of the financial markets. Throughout the course of history, this versatile product has grown as a result of multiple innovations and historically has provided both issuers and investors with better outcomes.

Important Disclosures:

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.

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