THE CONVERTIBLE INVESTOR
SPRING 2021

Financial *focus*

ADDRESSING THE NEEDS OF INVESTORS AND PLANTING THE SEEDS FOR A SECURE FUTURE.

The Best is Yet to Come: Happy 30th Anniversary Wellesley Asset Management!

This year marks Wellesley Asset Management's 30th anniversary! We are extremely proud of our history, the tremendous effort of employees and the trust and confidence our clients have placed in us over the years to grow and protect their assets.

Wellesley Asset Management (originally known as Millvest) was formed on July 23, 1991 primarily as a family office. In 1995, Greg changed the name to Wellesley Investment Advisors and decided to expand Wellesley's services to his CPA firm clients. The same year, the firm secured portfolio management and reporting software and began establishing an audited performance track record. Greg recognized the need for investments that both preserved and grew his CPA firm clients' wealth by investing in convertible bonds.

Greg sold the accounting business to focus exclusively on investment management in 2000. It was a decision not taken lightly, but with the continued growth of Wellesley, Greg and his team wanted to concentrate their time and resources on managing client portfolios. In the 2000's, Wellesley's growth continued with assets under management (AUM) breaking $100 million by 2003 and the launch of its flagship mutual fund, the Miller Convertible Bond Fund with almost $4 million in AUM in 2007. During its first full year of performance in 2008, the new mutual fund won a Lipper Award ranking #1 of 71 funds in its Equity Fund Performance Analysis Service in the convertible securities category for the one-year period ending December 31, 2008. The following year, Wellesley obtained its first institutional SMA client, one of the world's largest banks.

In 2010, Michael Miller, CFIP was promoted to co-portfolio manager of the Miller Convertible Bond Fund and assumed additional research, trading and client responsibilities. In 2011, Wellesley reached other milestones, as firm AUM topped $1 billion, the Miller Convertible Fund had grown to over $300 million and Greg was first named a Barron's Top 100 Independent Advisor. Three years later, AUM had doubled to $2 billion and the flagship mutual fund surpassed $500 million. In 2015, Greg Miller again was ranked #1 as the Top Financial Advisor in Massachusetts by Barron's and Wellesley Investment Advisors was honored to be featured in a Barron's August 24, 2015 magazine article. Also, in 2015 Wellesley launched two 40-act open-end mutual funds. In 2016, Wellesley continued its expansion, relocating to the top floor of 20 William Street in Wellesley Office Park, as our team grew to over 30 employees.

Since its formation in 1991, Wellesley has remained steadfast in its commitment to its people and technology. We strive to continue to make improvements in our processes to prepare for the future and remain flexible to adapt to change. We are proud that Wellesley continues to be recognized for outstanding achievement with Greg Miller's addition to the Forbes' America Top 250 Wealth Advisor list. Not to be outdone, Michael Miller was included in Forbes' list of America's Top Next Generation Wealth Advisors ranking #1 in Massachusetts and top 25 nationwide in 2020 for the fourth consecutive year. By the end of 2020, AUM grew past $2.5 billion and seemed to be heading toward $3 billion over the balance of 2021.

Our growth would not be possible without the support and confidence of our clients. We are extremely grateful and appreciate your patience, fortitude and trust in the investment process that has enabled Wellesley to help our clients pursue their long-term financial goals. We expect that to continue as we embark on our 31st year of providing investment expertise in the convertible bond arena.

SMARTER INVESTING:
Experience + Discipline

"Only when the tide goes out do you see who's swimming naked" -Warren Buffett

The Flood Gates are Open

The first quarter of 2021 has been a busy start to the year for new convertible bond issuance with 81 new deals with a value of over $41 billion. This ranks as one of the strongest starts to the year in recent memory, continuing the trend of robust issuance from 2020. The year is shaping up to be a monster for convertible new issuance and may shatter all previous records.

A robust new issue calendar is welcome news for convertible investors. It demonstrates a healthy and deep market, allowing for the broadening of potential investments to new companies and in different sectors. Most importantly, it allows for the organic reset of convertible bond prices. Out with the old and in with the new.

This is especially important for the team at Wellesley. Our bailiwick is to sell greatly appreciated convertible bonds and replace them with new paper that has the potential to appreciate. More importantly, the newly issued convertible bonds tend to be far more balanced than appreciated and outstanding convertibles, which are far more equity sensitive. As such, these appreciated convertibles provide very little bond-like characteristics.

Like everything, new issue pricing can at times be attractive and other times not. Wellesley concentrates its efforts on populating portfolios with what we believe to be attractively priced convertible bonds. Wellesley tends to avoid higher premium convertibles which decrease potential returns and consequently add unnecessary risk in our view. Wellesley also steers away from convertible preferred or mandatories which do not provide for a return of principal.

We expect the accelerating trend in new issuance to continue as companies take advantage of low interest rates and shore up their balance sheets. This natural evolution creates increased opportunities to construct well-diversified, balanced convertible bond portfolios, and improve the risk-reward paradigm of Wellesley's investment process.

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Chasing the Bull

One topic frequently discussed at Wellesley Asset Management is downside protection. A reason to focus on downside protection is that it takes a higher percentage return to make up for a given loss. For instance, in order to get back to even, a loss of 30% needs to be met with a 42.9% gain. Preventing catastrophic losses is a time-tested strategy for increased gains and substantial wealth creation.

2020 provided a short and rapid downturn in the markets. It was the first Bear market in many years, and unlike any in the past. While the overall economy was reeling from job losses and stay at home orders, the stock market, after a sharp and sudden drop, began a substantial rally. Blink and you missed the bear market.

Given the short-lived drop and swift recovery in equity prices, some investors may have forgotten the consequences of a prolonged drop in prices. The last sustained bear market occurred 13 years ago so memories may be distant. As a result, many investment professionals have only focused on potential returns as opposed to potential risks, and often tout investment performance without any mention of various risk measures. Memories become fleeting and caution gets thrown to the wind. Sometimes the hangover is much more extreme than the party.

The "this time is different" crowd takes faith that the Federal Reserve will come to the rescue during times of market stress. In many ways, it has been rather simple for investors to produce outsized returns over the past ten-plus years. Since 2008, the Federal Reserve has maintained incredibly low short-term interest rates and met every market sell-off with increased liquidity. It has allowed zombie companies to survive and permitted the idea of a rising tide lifts all boats. Most importantly, it has allowed those investment managers who disregard risk to not only thrive but to proliferate.

Whether such an environment continues is unknown. But Wellesley analyzes risk in much the same way as return, and does not have a short memory. Our 30 years of investing has taught us well, and the idea of chasing returns is foreign to our investment process and strategy.

What Makes Wellesley's Strategy Unique

Wellesley's investment strategy and investment process is unique from other convertible strategies and many fixed income managers. As opposed to some passive convertible investors who retain appreciated equity-like convertible bonds, or whose goal is to mimic popular indices, Wellesley instead proactively replaces appreciated equity-like convertible bonds with more balanced convertible debt. Wellesley is regularly re-constructing its portfolios so they are filled with balanced convertible bonds that have attractive risk-reward payouts. Given the historic rally in equities and resulting elevated prices of many convertible bonds, passively managing a portfolio and letting one's winners ride skews a portfolio toward increased correlation to the appreciated and often cited overvalued equity markets and exposes a portfolio to far greater risks. Wellesley greatly tries to mitigate those risks by being active with respect to portfolio reconstruction.

With risk mitigation in mind, Wellesley looks to construct a portfolio of convertible bonds that have an optimal balance between equity and debt. Such a balance is crucial in Wellesley's core philosophy of "winning by not losing". An appreciated convertible bond which closely mirrors its underlying common stock can be quite volatile and may be the reason behind convertible competitor's or even an index's substantial swing in value. If a convertible bond can double in a year, it can be cut in half the following. Rather than remaining passive, Wellesley actively replaces its winners with a new crop of balanced convertible bonds. This persistent and active repositioning of the portfolio away from equity-like convertible bonds and into more balanced ones is a hallmark of Wellesley's investment process.

Wellesley is also different from traditional fixed income managers. Many traditional fixed income managers invest in non-convertible debt that has very little sensitivity to the issuing company's equity price. As a result, these traditional fixed income managers tend to construct portfolios with relatively limited upside.

By definition, a traditional fixed income portfolio manager is loaning money to a corporation or government with the hope of receiving interest payments and ultimately the return of their principal investment. That's the one of the best-case scenarios – getting paid interest and receiving back one's principal investment. Conversely, like all investments, the worst-case scenario is a complete loss of one's principal. Wellesley, on the other hand, constructs a portfolio of convertible bonds which are more tightly correlated to equities. Unlike non-convertible debt, the upside in a convertible bond is unlimited as it tracks its underlying equity. Obviously, the downside risks of a complete loss of investment are the same.

Wellesley is therefore able to replace interest income with a convertible bond's underlying equity ideally improving the investments' risk profile.

With interest rates at historically low levels, the traditional fixed income manager's strong reliance on interest payments may be ill-advised as today's low interest payments become less valuable if interest rates were to rise. Fortunately, a Wellesley convertible bond portfolio given its modest correlation to equities is far less sensitive to the destructive effect of rising interest rates; history suggests that as interest rates move higher, convertible bonds not only outperform traditional fixed income but deliver positive absolute returns. Consequently, adding convertible bonds to a traditional fixed income portfolio may lessen the deleterious impact of rising interest rates on a non-convertible portfolio.

Wellesley Asset Management
Convertible Bond Specialists

Managing Risk by Rebalancing

Determining a client's risk tolerance is often one of the first steps in developing an advisor/client relationship. Asset allocations between various types of investments can be built around a client's risk tolerance and investing time horizon.

At Wellesley Asset Management, our convertible bond team is regularly rebalancing our client portfolios by selling highly appreciated convertible bonds and replacing them with more balanced convertibles priced near par.

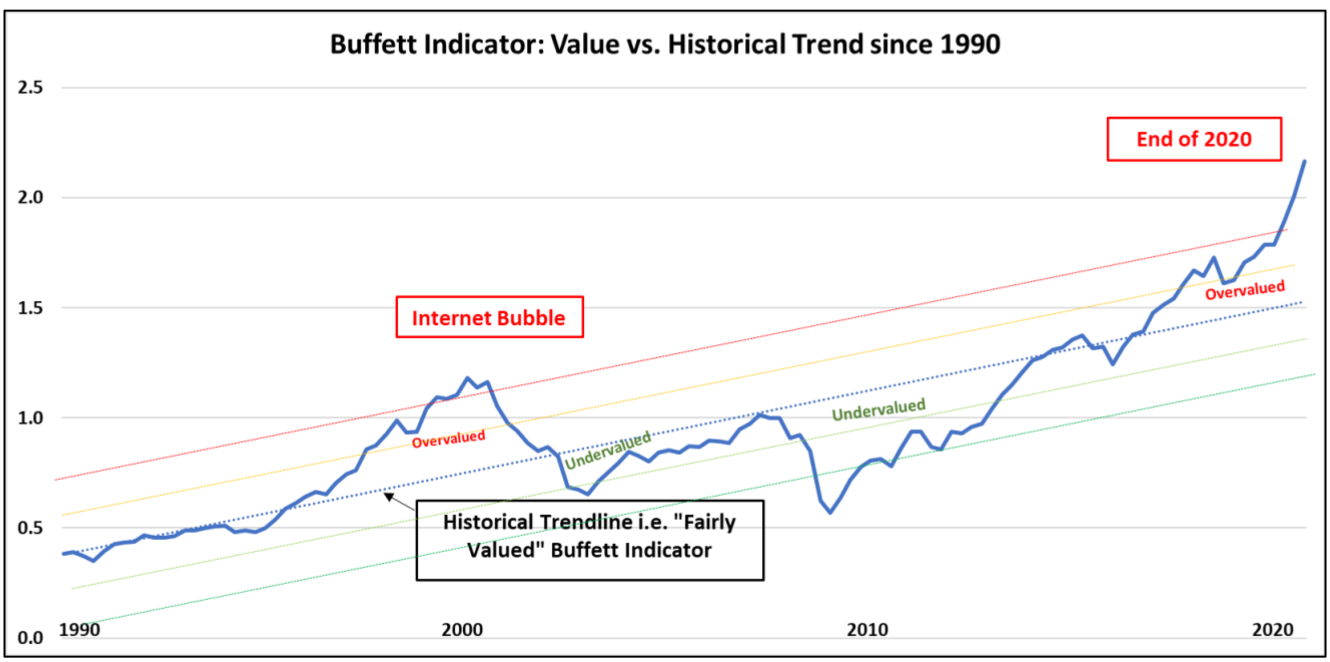
We go to great lengths to manage risk. Our investment process does not end with a thorough analysis of a company's financial statements and the technical attributes of the convertible bond. Just as the individual investor must rebalance their portfolio to maintain proper risk levels, at Wellesley Asset Management we also believe in portfolio rebalancing.

One key metric when rebalancing convertible bond portfolios is the average convertible bond price. At Wellesley, we prefer bonds trading around par, also known as balanced convertibles. These bonds provide a good mix of income and equity sensitivity while maintaining a reasonable level of risk. Portfolios with average bond prices significantly below par tend to provide adequate income, but have little equity exposure. Conversely, portfolios with average bond prices significantly above par may provide equity-like returns, but very little income.

Our average bond price is a good barometer in determining the risk in a portfolio. A high average bond price would be indicative of too much equity risk and would cause the sale of those highly priced convertibles redeploying the funds into more balanced ones. Alternatively, a low average bond price would mean too much credit risk. In such a scenario, selling low priced convertibles and buying bonds trading closer to par would occur. Throughout Wellesley's thirty years of investing the principle of active rebalancing is a central component of the investment process. Maintaining a portfolio's average bond price close to par provides the proper balance between risk and return.

Thoughts from Mr. Buffett and Professor Shiller

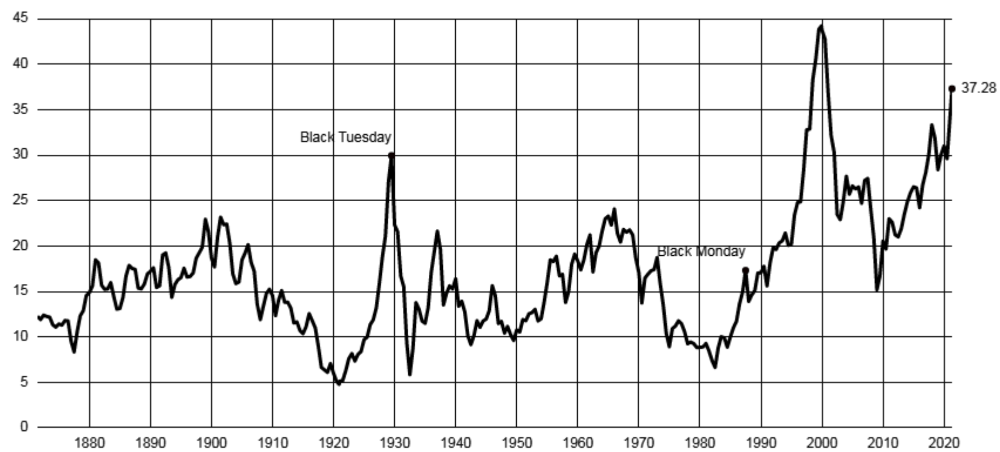
Warren Buffett, the world-famous investor and CEO of Berkshire Hathaway, recently discussed the idea of the "Buffett Indicator". Mr. Buffett previously wrote that many investors would have seen the dot-com crash coming from a mile away had they paid attention to what he described in a Fortune article in 2001 as **"probably the best single measure of where valuations stand at any given moment."** Known as the "Buffett Indicator", the measure is simply the total market cap of all U.S. stocks relative to the country's Gross Domestic Product.



Graph1 – The Buffett Indicator

Looked at today, it is sending some alarming signals. It has well-surpassed levels seen during the internet bubble and is approaching statistical anomalies similar to getting struck by lightning or winning the lottery. In theory, purchasing equities when the Buffett Indicator is at such high levels greatly reduces the chances of long-term investment success.

In the same vein, Professor Robert Shiller of Yale has developed the Shiller Price to Earnings (P/E) ratio, or often known as the Cyclically Adjusted Price-to-Earnings ratio ("CAPE"). The CAPE ratio is a valuation measure that uses real earnings per share (EPS) over a 10-year period to smooth out fluctuations in corporate profits that occur over different periods of a business cycle. The benefits of using the CAPE ratio are that it looks at longer time frames which remove spikes or drops in earnings which are often the result of one-off events or cyclical trends.



Graph 2 – The Shiller PE ratio or the CAPE ratio

The current CAPE reading, much like the Buffett Indicator is flashing extreme caution. Although not at all-time levels, the CAPE is at its highest reading except for the dot-com bubble. Like the Buffett Indicator, purchasing equities when the CAPE is at such high levels has resulted in sub-par investment returns. Based on these two longer term valuation indicators, increased exposure to equities is likely increasing investment risk and decreasing risk-adjusted returns.

It is worth noting, however, that both the Buffett Indicator and the CAPE ratio are not market timing mechanisms. Instead, they provide a holistic view of valuation and allow for a better understanding of risk, reward and valuation and are just one of many tools investors can utilize in order to make informed investment decisions.

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.

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.

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