The Convertible Investor

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

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Where to Put Your Next Dollar

The stock markets have reached new all-time highs, nearly 0% interest rates have brought record low bond yields, and many parts of real estate look overpriced making investors ask themselves, "Where do I invest my next dollar?" This is a challenging question in this environment but for many the answer may be convertible bonds. In our view, convertibles may offer an attractive investment for investors who want to have their cake and eat it too.

Let's take a look at the generic opportunity set for today's investors. The most common place to invest is in stocks. Stocks can be broken down into many sectors, such as large-cap, small-cap, growth, value, etc. Focusing on the big picture, we'll use the S&P 500 Index as a proxy for the overall stock market. This year through August, the S&P 500 is up 9.74% even with the global pandemic and the market falling approximately 35% from its peak back in February. As of this writing, the market continues to reach all-time highs. Yet, with the all-time highs, there are many signs that the markets are heavily overvalued.

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First, the average price to earnings for the S&P 500 (P/E Ratio – i.e. the price you have to pay for the earnings of a company) is the highest it has been since the 2008 Financial Crisis, reaching an average of 27.3 in August.

This is a solid indicator of how expensive stock prices are for investors. Additionally, the S&P 500 has become highly concentrated around a few large-cap technology names with monetary and fiscal stimulus as a response to the global pandemic fueling prices even further. Technology stocks such as Apple, Google and Amazon have appreciated significantly during this period resulting in even higher weightings in the market indices; therefore, causing investors to have even less diversification than before the pandemic.

The next typical place to invest is fixed income or bonds. Traditional bonds have experienced one of the longest running bull markets in history as yields fell from over 16% in 1981 to less than 1% in 2020. With all time low interest rates however, most generally agree that the only place for interest rates to go is higher. As a rule of thumb, as interest rates increase, the value of the bond falls. Therefore, investors within bond mutual funds could experience near zero or negative returns for a period of time. The difference between convertibles and traditional fixed income during the last six periods of rising interest rates is striking, with the Bloomberg Barclays Aggregate Bond Index falling on average 1.74% while the Wellesley Asset Management Composite[1] returns rose 9.57%.

The other area that concerns us with traditional fixed income currently is credit quality. There has been a 40% rise in the level of investment grade credit over the past five years, yet a number of companies have taken on significant levels of debt on their balance sheets. For example, Lowe’s has increased debt by 23 times between 2010 and today with long-term debt over $24B. This has been the case for other companies, including many airlines, cruise lines and the hospitality industry. Many mutual funds have been buying these bonds searching for higher yields but therefore, buying more bonds with increasing credit risks. In a time of uncertainty, we believe it is extremely important to buy “quality” companies that have a lower risk of default if the economy does not improve quickly.

The third common investment area for investors is real estate. The real estate market is very interesting during this time. Real estate in urban areas such as San Francisco, Boston and New York saw supply increases as many families looked to gain more space in the suburbs and escape the pandemic. This created excess supply from both a purchase and rental perspective in these major markets. Surrounding areas have seen their values gradually rise as time and demand pressures have increased. On the commercial side, the world almost changed overnight for many cities; the economics for restaurants, hotels, and local businesses shifted from the strongest surge in years to dire straits. We have seen a glimpse of this as some real estate investment companies have begun to fail with debt rising and lease defaults. This is changing the real estate market in ways that many investors have not seen before. For individuals that are able to gain access to the private real estate market via partnerships or funds, the ability to reap returns during this time is truly dependent on the skill of the manager.

With the typical areas to allocate capital near all-time highs, where is an investor to turn be-

sides cash? In our opinion, this is an ideal time for actively managed convertible bonds that, barring the bond's default, provide a return of principal, potential coupon payments and upside stock potential. At Wellesley Asset Management, we are focused on protecting investors while seeking to garner upside participation of the stock market. We do this with a focus on understanding the debt side of the equation for each business. This attention to detail has historically allowed both the preservation of capital and upside market participation.

Why Companies Issue Convertible Bonds

We often talk about the many advantages that buyers of convertible bonds enjoy. Because of the hybrid nature of the product, convertibles can be used to satisfy a fixed income, equity or alternative mandate. When added to a portfolio, convertible bonds can increase returns and lower risk, thereby improving the efficient frontier. However, for a market to exist, there must be supply, or sellers of convertible bonds. This article looks at convertible bonds from an issuer's perspective and examines why companies issue convertible bonds.

First and foremost, a company issuing convertible debt can do so at an interest rate that is lower than the rate to issue non-convertible or straight debt. Investors of convertible debt are willing to accept a lower coupon in exchange for the chance to participate in the potential appreciation of a company's stock. To illustrate this point, we will look at a couple of instances where a company has simultaneously issued straight debt and convertible debt.

On April 9, 2020, Booking Holdings Inc., an investment grade company, issued a .75% convertible bond due 5/1/25. The day before, the company had issued a 4.1% straight bond due 4/13/25.* There is a slight maturity mismatch but you can see the company was able to issue the convertible debt with a coupon 3.35% lower than where its issued straight debt.

The discrepancy between financing costs is greater for non-investment grade companies. For example, on April 1, 2020, Carnival Corporation issued a 5.75% convertible bond due 4/1/23. On that same day, the company also issued an 11.5% straight bond due 4/1/23. The issue price of this bond was 99; the bonds actually yielded 11.90%. In this instance, Carnival was able to issue convertibles with an interest rate that was 6.15% lower than where it issued straight debt.

Another advantage to issuing convertible debt is that it allows a company to access a different investor base providing financial flexibility. Though the convertible market is smaller than the investment grade bond and high-yield markets, it does represent a unique investor base. Between convertible arbitrage hedge funds (firms that hedge their exposure by shorting stock against the convertibles they hold) and long-only funds (firms that do not hedge), there exists an investment community that solely focuses on the convertible bond market. In the case of Booking Holdings, the company issued $3.25 billion of straight debt with maturities from five to thirty years. By accessing the convertible market, the company was able to issue an additional $862.5 million of five-year convertible debt. Similarly, Carnival Corporation desired to raise capital in April of this year. Originally, the company was looking to sell

equity, debt, convertible debt and European debt. However, due to low demand, the European offering was cancelled, and the company was able to increase the size of the straight debt and convertible debt offerings.

Some convertible bonds have a call feature which can provide the issuing companies with balance sheet flexibility. Convertible bonds with calls are usually callable after a three-year time period. If a company's convertibles have traded up, and company management wants to reduce debt and increase equity, they can simply call the bonds.

Convertibles may be the best financing option for small capitalization companies and companies whose stock is very volatile. Many small-cap companies have never accessed the fixed income markets and, therefore, do not have a credit rating. In addition, because of their small market cap, these companies typically issue amounts of debt that are too small for the straight debt markets. Convertible investors are used to investing in companies that don't have bond ratings (over 60% of the market is non-rated) and companies that issue small deal sizes. Furthermore, companies whose stock is volatile can get advantageous financing in the convertible market. Volatility is one of the most important factors in the value of an option. For higher volatility stocks, the cost of their options tends to be higher. The greater the value of the embedded option in a convertible bond, the lower the coupon the company will have to pay. For this reason, the convertible market has large allocations to the technology and biotechnology sectors.

There are two other reasons why companies issue convertible bonds. Convertible issuers can raise capital very quickly compared to other forms of financing. It is not uncommon for large convertible deals to be announced after the market close, and be priced before the market opens the next day. In addition, like other forms of debt, the interest on convertible bonds is tax deductible, which effectively lowers the cost of financing.

The convertible market has grown substantially since the first convertible bond was issued in 1874. With the mutual benefits provided to both issuers and investors, we expect that convertible bonds will continue to thrive as an important source for companies to raise capital and for investors who seek to grow and protect their wealth.

**This bond was actually issued at a small discount to par resulting in a slightly higher yield.*

Convertible Bond Investing: *Don't Try This at Home*

With the advent of websites such as Robinhood and Acorns, many individual investors feel empowered to manage their own investment portfolios. These websites make it easy for the retail investor to buy equities, ETFs, and bonds. However, there are some markets that the individual investor should not delve into on their own. While municipal, high-yield, and convertible bonds come to mind, we want to focus on why investing in convertible bonds is best left to a professional money management company with an active focus.

Transaction costs can eat into any investor's returns. In less liquid markets, such as municipal, high yield and convertible bonds, the bid/ask spread, or price where a dealer will buy and sell bonds, can be quite large. Normally, a large institutional investor can trade for a one-point wide bid/ask. Since we normally trade bonds whose prices are around par value, that works out to a 1% bid/ask spread. There have been instances where we have sold bonds to a dealer at par, or 100, only to see that dealer markup the bonds and sell them to retail clients at 102 or 103. (The convertible market is transparent, and all trades are made public by a reporting facility). At Wellesley Asset Management, we are considered by convertible bond brokers to be an institutional account because we manage over $2 billion in

convertible bonds. Since we do a lot of business with major Wall Street firms, we get institutional pricing regardless of the size of our transactions. Large block convertible purchases result in better prices for our clients.

In addition to lower transactions costs, there is another advantage to being an institutional account in the convertible market. By virtue of the business we do with Wall Street firms, we get access to the new issue market which typically restricts retail investor participation. Not only do we get to pick which new deals we want to purchase for our clients, we also get good allocations on these deals. This is especially true in deals where we are *"wall-crossed."* Wall crossing is a process whereby Wall Street bankers select a handful of potential buyers of a deal. As a potential buyer, we receive material non-public information about the issuing company and the proposed transaction. As a result of this, we are legally bound not to trade in any securities of the issuing company. If we like a deal, our indication of interest in the proposed transaction gives the banker the confidence that the convertible bond issue will be well-received by the convertible community. As the result of our early commitment to the deal, we tend to get the allocation of bonds in the new offering of what we are asking for (or close to it). Why is all of this important to our clients? New deals are a source of alpha for convertible managers often boosting returns. In order for the deals to be bought by market participants, they often times sell below their fair value, resulting in what is commonly known as the *"first day pop."* First day pops on many issues can be 1% or 2%, but we have purchased some as high as 10% or more. Not a bad return for one day! This is similar to what can happen on the first day of trading a newly issued stock on an initial public stock offering.

Perhaps most importantly, retail investors should not invest in individual convertible bonds because each issue comes with a document known as an indenture which contains all of the particulars about a convertible bond issue. Indentures are usually over 100 pages long and include information about corporate actions such as convertibility, penalty interest, inducements to extend maturity, and changes of control at the corporate level. It is hard enough to stay apprised of the rights of bondholders for one issue; never mind a diversified portfolio of 20 or 30 different convertible bonds. Mistakes in these matters can be costly. For instance, while a company's ability to call a bond can last for years, investors' ability to put bonds back to the company happen on discrete dates. If an investor misses the put date, they could immediately see a decline in the value of their investment.

More costly for investors are missing notifications that a company has exercised a "call" on a bond. Imagine holding a bond that is trading at 175 and missing the press release that states the company is calling the bonds at 100. Rather than selling or converting the bonds at market prices, the investor will unknowingly receive a much lower price for the bonds. In this example, the convertible bond investor would lose about 43% in market value in one day instead of earning a profit on the convertible bond of 75%! Situations like this are the reason why you should hire a seasoned manager to research, follow and use skilled judgement to make profit maximizing decisions on your behalf.

While individual investors may be well-served on websites that cater to the “do it yourself crowd,” they would be “pennywise and pound foolish” to try going it alone with convertible bonds. High transaction costs and missing corporate action announcements can prove costly for individual investors while missing out on the new issue market can be a large opportunity cost. When it comes to convertible bond investing, investors should not try this at home. Instead, they should leave the management of convertibles to a seasoned investment manager with many years of experience investing in and trading convertible bonds.

Do You Know What’s in Your Index Fund?

The "Anti-Quality" Factor Exposure

The rise of ETFs and index mutual funds for both professional money managers and individuals has been a growing trend over the past 10 years. There are pros and cons of using index funds within all asset classes. For example, the Large Cap Growth Class has seen growing exposure to technology stocks as the market capitalization of tech’s top 10 companies has soared. This concentration can be a positive development, not just in terms of performance, but also with regard to the quality of the companies. Other times, as many institutional investors know, this can create risk. One of the most popular convertible bond indexes is the ICE Bank of America US Convertibles ex Mandatories TR Index (V0A0). In our analysis, the index has an “anti-quality” factor bias. We believe this is due to the fact that many of the companies in the V0A0, particularly the largest exposures, have negative earnings per share (EPS) and high levels of debt. This is a concern for us as quality of earnings within bear markets have truly mattered. Let’s review a few of the largest issuers within the V0A0 in terms of quality, compared to the Wellesley Asset Management strategy via the Refinitiv Wellesley Convertibles Index (RWC0).

First, in terms of performance of the V0A0 compared to the RWC0, the former has done very well of late. Year to date, the V0A0 is up 28.98% through the end of August compared to the RWC0 up 17.1%. However, when we look at longer term performance, the story changes. The V0A0 over the past 20 years, is up 6.87% annualized, while the RWC0, over this time period is up 7.61% annualized. While both of these products have outperformed the S&P 500 (U.S. Stocks), the Bloomberg Barclays Aggregate Bond Index (U.S. Bonds), and a 60/40 portfolio of the S&P 500 and the Bloomberg Barclays Agg, the RWC0 has done this with a lower standard deviation than all of them. This an important point, as we have discussed before; quality of earnings within the stock market is out of favor occasionally, sometimes years at a time, but over the long term it is important.

When comparing the V0A0 and the RWC0, both invest in convertible bonds but that is where the similarities end. The V0A0, like many index products, is market capitalization weighted. This means that the largest convertible bond issues receive the largest weight within the index. One area of particular importance to note for convertible bond managers is the delta of the portfolio. "Delta" is a measure of how much a convertible bond moves up and down relative to its underlying stock. For example, a convertible bond with a delta of 0.6 would be expected to rise or fall about 0.6% on a day the issuer's stock rises or falls 1%. Currently, some of the largest issuers within the index include: Tesla, Advanced Micro Devices, ServiceNow and Sea Limited.

Each of these have bond prices that have risen significantly over the past few years, along with deltas near 1 (meaning they trade very similar to the stock). First, Tesla is a company that has had massive growth in recent years. Currently, this one company's three convertible bond issues represent over 8% in the CWB ETF, a proxy for the V0A0. This has driven a large portion of the index's return for 2020 and has given investors an even greater exposure to their issues. Investors in the V0A0 will have to accept that they are investing in essentially the stock of Tesla.

Next, Advanced Micro Devices is a company that has seen its stock explode over the past five years. They have one convertible bond issue that is currently priced over $10,000 per bond. However, the company only guarantees return of principal of $1,000 per bond, so the value of this bond can fall over 90% before it matures on September 1, 2026! Similar to Tesla, this convertible bond trades very similar to its stock, with a delta over 0.98. ServiceNow, is another technology company whose shares have soared since its issuance. The bond does not pay a coupon to investors and does not have a credit rating. Sea Limited, a South East Asian e-commerce company has a convertible bond paying 1%. The company does not currently have positive earnings and has a debt to equity (D/E) ratio over 4.

Of the two names that have over $1B in debt, Tesla has a debt to free cash flow (D/FCF) over 8, and Sea Limited has negative free cash flow. Rather than increasing profits, the value of these companies has largely been driven by multiple expansions.

The RWC0 on the other hand, is focused on high-quality companies, with reasonable balance sheets and earnings growth. Some of the largest issues within the RWC0, none of which are in the V0A0, include: Newmont Mining, Apple, Amazon and Johnson & Johnson.

Each of these companies have strong earnings and quality balance sheets. Newmont Mining, an investment grade bond whose principal is guaranteed by Barclay's Bank, is a synthetic convertible bond that we purchased in 2018 that has done very well. We have participated in a large portion of the upside of the stock. Similarly, Apple and Amazon, both investment grade bonds with the principal guaranteed by JP Morgan, have both done very well as synthetic convertibles and as the prices have increased, we've trimmed positions and taken profits for investors. That is another key difference between the RWC0 and the V0A0; we seek to limit exposure in one company/issue, compared to the V0A0 which is designed to increase the weight of a company as it does well and it goes up in price.

During our experience of managing convertible bond portfolios for clients, we have seen the ups and downs of the market. In the good times, investments in bonds with deltas near 1 and prices over 200, allow investors to potentially capture greater returns, but at the expense of potentially large losses during a bear market. This is why we focus on the quality of the company and, unlike the V0A0, on bond-like principal protection. We've witnessed index funds and ETFs that track our market become more popular over the years. This causes concern, as we have outlined above; it has created an "anti-quality" factor for these companies.

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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[1] 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 later than December 2018 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.

Returns are net of management fees shown. 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.

<u>Footnotes Pertaining to Years Up to and Including 2009</u>: 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 WAM's client accounts. 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 WAM client accounts is different, in some cases substantially, from the performance presented for convertible securities.

WAM'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 WAM believes to be reliable, WAM 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.

<u>Footnotes Pertaining to Years After 2009</u>: 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 WIA Composite for the first full month under management and are removed from the WIA Composite at the end of its last full month under management.

Footnotes Pertaining to Years 2016 and after: Beginning January 1, 2016, the WIA 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 accounts consist of institutional investors, including pensions, profit sharing plans, defined benefit plans, defined contribution plans, hospitals and not-for-profit organizations.

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