THE CONVERTIBLE INVESTOR
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Financial *focus*

PLANTING THE SEEDS FOR A SECURE FUTURE

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Higher Interest Rates May Provide Opportunity

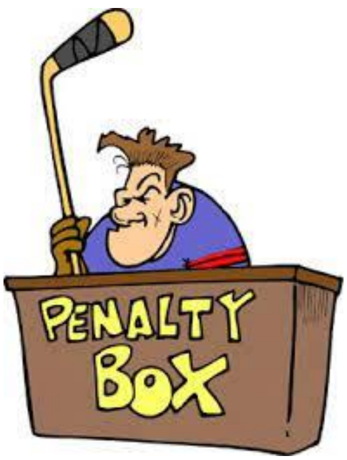
Interest rates spiking over the past year, may provide a tailwind for future returns, especially when it comes to new issue convertible bonds. As many know, interest rates have risen from extremely depressed levels over the past 12 months. Those low interest rates fueled the substantial issuance of convertible bonds in 2020 and 2021. With interest rates rising and increased uncertainty regarding the economic outlook, convertible bond issuance was almost non-existent during the first half of 2022. However, that has changed recently.

In 2020, there was $100.5 billion of new convertible issuance in the U.S. The average yield was 2.28% with a 32% premium. In 2021, there was $84.5 billion of new convertible issuance in the U.S. The average yield dropped to 1.11% and the premium jumped to 39%. Very recently with the increase in issuance occurring since July 2022, issuance over the past few months has not only begun to accelerate, but is coming to market with incredibly favorable terms. Since July 1, 2022, there has been $10.1 billion in convertible issuance in the U.S. with vastly improving terms – 3.84% yield and only a 29% premium.

United States Convertible New Issuance*

	Gross Proceeds ($B)	# Issues	Yield	Premium
2020	100.5	181	2.28%	32%
2021	84.5	164	1.11%	39%
7/1/22-9/22/22	10.1	16	3.84%	29%

Higher yields and lower premiums are a good thing for convertible investors and clearly provide an opportunity going forward. As new issue convertible yields now approach 4%, investors can get paid to wait for the underlying equity to appreciate. Further, with new issue premiums below 30%, investors likely can participate in a substantial amount of the underlying equity's upside if markets rally.



It is always painful for assets when interest rates move higher especially over a very short period of time. Once rates hit those higher levels, those higher interest rates can provide a tailwind for returns as interest bearing securities such as convertible bonds now provide a more material yield. The idea of being penalized for being a conservative bond investor gets thrown out the window, and investors may once again get paid positive nominal yields by owning fixed-income securities. The new issue convertible market is a prime example of those better yielding type of opportunities going forward, and a situation where sunnier days may be around the corner.

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The Benefits of Using Convertible Bonds in Rising Rate Environments

Higher interest rates hurt the value of fixed-income investments. The most common measure of an investment's sensitivity to interest rates is something called bond duration. This measures the change in a bond's price to changes in interest rates. Duration is measured in years and is by definition the time it takes to be repaid the bond's price by the bond's total cash flows – the bond's regular coupon payments and the repayment of principal at maturity.

Importantly, the higher or longer a bond's duration, the higher it is sensitive to changes in interest rates. Conversely, the lower or shorter a bond's duration, the less sensitive it is to changes in interest rates.

If an investor believes interest rates are heading higher, they should decrease the duration of their holdings. By their nature, certain fixed-income asset classes have very different durations. The chart below depicts the effective duration of different asset classes as represented by their respective ETF's. Our convertible bond strategy is represented by the below WIA composite.

Name	Symbol	Duration*
iShares Core U.S. Aggregate Bond ETF	AGG	6.44
iShares TIPS Bond ETF	TIP	7.07
iShares iBoxx $ Investment Grade Corprate Bond ETF	LQD	8.58
iShares iBoxx $ High Yield Corporate Bond ETF	HYG	4.13
iShares BB Rated Corporate Bond ETF	HYBB	4.58
iShares MBS ETF	MBB	6.45
Wellesley Investment Advisors Composite (WIA)[1]	WIA	2.12
*Effective Duration as expressed in years (a/o 8/31/22)		

Investment grade corporate bonds have the longest duration and greatest sensitivity to higher interest rates. Conversely, convertible bonds have the shortest duration and least sensitivity to interest rates as they have shorter durations since they are typically issued with shorter maturities. In addition, because convertible bonds are often converted into common stock well before they mature, the time to it takes to realize the return of investment principal is less and therefore the duration of a convertible bond is shorter.

Given convertible bond's decreased sensitivity to interest rates, an increased allocation to shorter duration convertible bonds makes sense if interest rates are expected to rise. With inflation becoming more entrenched and a Federal Reserve determined to reduce inflation to their mandated target, higher interest rates may become the norm. Convertible bonds may offer the perfect solution to the conundrum of where to allocate fixed-income assets in a rising interest rate environment.

Heed the Inverted Yield Curve

Most often, the longer an investor loans money, the more unknowns, the greater the risks and the greater his expected return or yield. The same concept occurs in the U.S. Treasury market.

For example, an investor expects to get paid more via a higher yield the longer the investor loans the U.S. Government money. That positive relationship of higher returns or higher yields for longer time frames can be associated with the risk-return paradigm (more risk equals higher expected returns), and in yield curve parlance, often referred to as an upward sloping yield curve. Throughout most of financial history, that idea of greater returns being associated with longer time frames has been the norm, and an upward sloping yield curve occurs almost all of the time. The below is an example of a typical upward sloping yield curve:

But, there are a few times when the U.S. Treasury yield curve is not upward sloping and investors demand higher expected returns for shorter periods of time. In these rare instances, the U.S. Treasury yield curve becomes inverted, i.e. when shorter term rates are higher than longer term rates.

We are currently in one of those rare periods when short term interest rates are much higher than long term interest rates.

In essence, investors are aggressively selling shorter dated debt and buying longer dated debt (bond price and yield are inversely correlated). Why? These fixed-income investors are locking in longer term yields today under the assumption that yields will be much lower at some point over the coming years. In addition, investors are reluctant to purchase shorter dated debt believing that reinvesting the principal when that debt matures (in relatively short period of time) will possibly occur at substantially lower yields.

Importantly, when short term rates are substantially higher than long term rates it also signifies an economic slowdown is in the making. In fact, since the 1970s, the yield curve has become negatively sloping before each U.S. recession. In other words, an inversion of the yield curve, in which short-maturity interest rates exceed long-maturity rates, is typically associated with a recession in the near future.

Paying attention to interest rate levels is always important, but paying attention to the slope of the yield curve has historically provided some degree of predictive power when trying to better understand future economic activity.

Synthetic Convertibles go Mainstream

In December of 2020, Wellesley Asset Management published a white paper discussing the benefits of synthetic convertible bonds. As a refresher, synthetic convertible bonds are issued by banks and with the convertible into individual stocks. In many ways they are similar to a traditional convertible bond, but they are not convertible into the issuing corporation. Unlike traditional convertible bonds, synthetic convertible bonds are not dilutive to the issuing entity, tend to be of far superior credit quality, and are often convertible into large cap corporations.

The benefits of investing in synthetic convertibles include diversification (sector, market capitalization, and credit quality), uncorrelated equity and credit returns, balanced risk profiles and the ability for the investor to pick the timing of the issuance of the synthetic. Most synthetic convertibles that Wellesley Asset Management purchases are transactions in which Wellesley is the sole investor, helping to structure the synthetic convertible bond. However, due to lackluster and sparse issuance in the convertible market throughout 2022, a few synthetic convertible bonds have come to market recently that target a broader investor audience and appeal to multiple buyers.

Like Wellesley, in December of 2020, Bank of America more recently published a research paper on the benefits of synthetic convertible bonds. Bank of America commented that due to rising interest rates and lower equity prices, approximately $19 billion of new convertibles have been issued as of September 1, 2022. Interestingly, about 13% of the new convertible issuance has been synthetic convertible transactions; and nearly half of the synthetic deals are convertible into companies with market capitalizations over $100 billion. This compares to just 8% in the traditional convertible market.

From a performance perspective, synthetics have exhibited their defensive nature in 2022 having lost only 7.90% as compared to the ICE Bank of America G300 index, which is down 12.60%. There are a variety of reasons for synthetic's out-performance, including the non-dilutive aspect of their structure and the higher credit quality of the issuing entity. Nonetheless, given the wide array of benefits synthetic convertibles provide, it's easy to see how the use of this asset class might improve risk-adjusted returns.

Wellesley Asset Management has not invested in any of the broader synthetic deals that have come to the market this year, but continues to work with individual banks to create Wellesley-centric deals, recently purchasing two synthetics that are convertible into Amazon and Target.

Wellesley believes Amazon is attractive given a sharp sell-off in Amazon's equity price as analysts have reduced forward earnings estimates over concerns of higher labor costs cutting into profit margins. Even with these earnings revisions, Amazon remains a high growth stock with analysts expecting earnings to grow 134%, 60%, and 23% respectively over the next three years.

Given Amazon's growth outlook, Wellesley swapped an existing Amazon synthetic convertible bond that was maturing in about 7 months for a new Amazon synthetic maturing in 3 years. The new 3-year synthetic afforded a far longer time frame for Amazon's stock to potentially appreciate. A 3-year structure is also far less interest rate sensitive than traditional convertible bonds that mature in 5 years or more.

In addition, Wellesley purchased a synthetic convertible into Target. Given a precipitous drop in Target's equity price, there is lot of bad news priced into Target's stock according to many analysts. One issue facing Target is that earlier this year the company over-ordered due to supply chain concerns. As a result, the company had to discount prices to move inventory. Throughout the course of this year, Target has cut guidance twice. As of early September, the stock was down 28% year to date while the S&P 500 was down only 16%.

But it is important to note that Target's earnings, return on equity, and return on assets are all significantly higher than pre-pandemic levels. In addition, Target stock trades at a price to earnings multiple (P/E) of 14.4; below its 10-year average of 15.9, S&P 500's 16.8, and Walmart's 21.4. Given its cheap relative valuation and potential for improving growth, Wellesley believes Target stock could outperform regardless of the economic outlook.

We are excited about these latest synthetic investments and look forward to adding more to the portfolios in the near future. Synthetics are a very reasonable alternative given the substantial drop in equity prices and the material back-up in interest rates. We are also happy that the market has embraced synthetic convertibles as the product goes mainstream and others recognize their many benefits. The convertible market is constantly evolving to keep up with changing market conditions. The idea of creating bespoke convertible investments via synthetic convertible bonds which provide portfolio diversification with potentially higher risk-adjusted returns may be the perfect solution to address this year's meager traditional convertible new issuance.

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As always, thank you for your trust and confidence in our strategy. We hope you enjoy the articles within this newsletter and please feel free to share with friends and family.

Past performance is not a guarantee of future results.

Investments in convertible securities subject the Fund to the risks associated with both fixed-income securities, including credit risk and interest risk, and common stocks. A portion of the Fund's convertible securities may be rated below investment grade. Exchangeable and synthetic convertible securities may be more volatile and less liquid than traditional convertible securities. 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. Lower rated fixed-income securities are subject to greater risk of loss of income and principal than higher-rated securities. The prices of lower rated bonds are likely to be more sensitive to adverse economic changes or individual corporate developments. All fixed-income securities are subject to two types of risk: credit risk and interest rate risk. 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.

[1]Wellesley Investment Advisors Composite (WIA) is a strategy that invests in U.S. dollar-denominated convertible securities. Seeks to preserve capital and aims to outperform both equities and fixed income over complete market cycles.

BAML G300 Index is used to represent the broader convertible market.

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