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# Wellesley Asset Management Commentary

By Jim Buckham, CFA, Portfolio Manager | October 2016

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## Third Quarter Total Return Comparison (% through 9/30/2016):

	Q3 2016	YTD	1 Year	3 Years*	5 Years*	Since Inception 12/31/2007*	10 Years*	Since 1/1/2000*
Miller Convertible Bond Fund I (MCIFX)	5.55	8.65	11.43	6.46	9.62	6.87	N/A	N/A
TRW	6.27	10.26	13.06	7.50	10.44	7.68	7.81	8.58
S&P 500 TR	3.85	7.84	15.43	11.16	16.37	6.86	7.24	4.34
Bloomberg Barclays U.S. Aggregate Bond	0.46	5.80	5.19	4.03	3.08	4.54	4.79	5.48
VOA0	7.41	8.87	10.01	7.08	11.53	7.20	7.22	5.27

*The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost.*

*Please review the Fund's prospectus for more information regarding the Fund's fees and expenses including other share classes. For performance information current to the most recent month-end, please call toll-free 877-441-4434.*

*Total operating expenses for the Miller Convertible Bond Fund are Class A 1.44%, Class C 1.94% and Class I .94%.*

*See index descriptions and accompanying footnotes.*

*\*Returns are annualized.*

## Third Quarter Update

The 3<sup>rd</sup> quarter of 2016 was characterized by low volatility in the markets and large amounts of new issuance in the convertible market. The capital markets stabilized after the volatility caused by Britain's announcement to leave the European Union in late June. The ensuing calm in the markets paved the way for new all-time highs in major stock indices and a slew of deals in the convertible bond market.

The summer doldrums were in full force in the most recent quarter. Economic data continued to be erratic, causing the Federal Reserve to keep interest rates at current levels at their September meeting. Equity market volatility remained in check as the S&P 500 recorded its lowest level of volatility since the 1960s. In fact, there was a stretch of 43 consecutive days in the quarter where the index did not move more than 1% on any given day.

Typically, the summer months are the slowest time for new issuance in the convertible bond market. However, with equities drifting higher and yields drifting lower, the summer was the perfect time for companies to issue convertible debt. Over \$14 billion of new issuance came in the 3<sup>rd</sup> quarter. We had a deal the last week of August and four deals announced the day after Labor Day – something that we haven't seen in our twenty plus years in the business.

Despite the large volume of new issuance, convertibles outperformed both stocks and bonds for the quarter. The TRW was up 6.27% while the S&P 500 Total Return Index was up 3.85% and the Bloomberg Barclays U.S. Aggregate Bond Index was up 0.46%.

Looking ahead we see a few potential catalysts for increased market volatility in the coming quarter. A surprise result in the presidential or congressional elections in November could spur market activity. In December, the Federal Reserve is expected to increase the federal funds rate which could also lead to market volatility.

Convertible bonds can be utilized to protect portfolios during times of market volatility. With many different options to choose from, it can be difficult to select a convertible bond manager that is right for you. We recently published an article that looks at the risk-adjusted returns of various convertible managers and have included that article with this commentary. We hope that you will conclude, as we have, that our absolute return strategy that employs balanced convertible bonds may be the best way to protect principal in times of market volatility.

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## Risk-Adjusted Performance and the Sharpe Ratio

By Sean Edelman, Associate Portfolio Analyst

Last time you researched a new investment strategy or mutual fund to add to your portfolio, what was the ultimate deciding factor on what you picked? Most investors' response would be a resounding "performance!" The most prominent figures in the investment world like Carl Icahn and Bill Ackman are famous because of how strong their raw performance has been for their investors. But the truth of the matter is that with large returns often comes a large amount of risk, and most investors do not have nearly as strong of a risk appetite as they might think they do. When investments start experiencing large amounts of volatility, many get skittish seeing their portfolios losing money and sell out of a mutual fund at a loss, most likely missing out on the recovery when asset prices rise again. Jumping from strategy to strategy when things get rocky is an easy way to achieve long-term under-performance.

Therefore, we believe a superior way to help determine which mutual fund strategy fits your portfolio would encompass both the performance of the fund *and* how much risk, or volatility, the fund takes on to achieve that performance. This is known as risk-adjusted performance and fortunately there is a simple and useful measure to calculate it called a fund's **Sharpe ratio**.

Sharpe ratio is a measure that takes the performance of an investment and factors in the volatility of that investment over the same time period. All things equal, a higher Sharpe ratio for a fund may be better, just like when comparing raw performance. In technical terms, the Sharpe ratio is defined as "a measure that indicates the average return minus the risk-free return divided by the standard deviation of return on an investment." While that may seem very technical, it's actually rather simple: average return is the performance of the investment, risk-free return is the return one would get by investing in an essentially risk-free investment like a 3 month U.S. Treasury Bond, and standard deviation is a measure of the volatility, or risk, of the investment. This is what it looks like in equation form:

$$\text{Sharpe Ratio} = \frac{\text{Return} - \text{Risk}_{\text{Free}}}{\text{Standard Dev}}$$

Let's use a hypothetical example to illustrate how it works: an investor is trying to decide whether or not to invest in the ABC Mutual Fund or the XYZ Mutual Fund. Over the past year, ABC has had a total return of 10% and a standard deviation of 5%, XYZ returned 15% and had a standard deviation of 10%, and the risk-free rate was 1%. On a quick glance at performance, one would think that XYZ is the preferable investment as it outperformed ABC by 5%, but let's plug those figures into our Sharpe ratio equation and see if it tells a different story:

$$\text{ABC Sharpe} = \frac{10\% - 1\%}{5\%} = \frac{9\%}{5\%} = 1.8$$
$$\text{XYZ Sharpe} = \frac{15\% - 1\%}{10\%} = \frac{14\%}{10\%} = 1.4$$

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Even though the XYZ Mutual Fund had a higher return than the ABC Mutual Fund, ABC had a higher Sharpe ratio, meaning it outperformed XYZ on a risk-adjusted basis. A savvy risk-averse investor would therefore then choose ABC over XYZ as the Sharpe ratio shows that ABC is gaining more return per each unit of risk than XYZ Mutual Fund.

At Wellesley we have always been risk-averse investors, hence our LRI strategy of building portfolios of balanced short-duration convertible bonds with the goal to outperform over full market cycles, and which can lead to outperformance on a risk-adjusted basis. We believe that investors don't like enduring risk in their portfolios and our balanced convertible strategy aims to provide strong performance with low volatility. Here's how our flagship mutual fund, the Miller Convertible Bond Fund (MCIFX), has compared to its competitors\* on Sharpe over the past 1 year, 3 years, 5 years, and since inception of 12/31/2007:

Annualized Returns as of September 30, 2016								
Convertible Fund Name	1 Year Return	1 Year Sharpe	3 Year Return	3 Year Sharpe	5 Year Return	5 Year Sharpe	Return since MCIFX Inception	Sharpe since MCIFX Inception
<b>Miller Convertible Bond (MCIFX)</b>	<b>11.43%</b>	<b>1.18</b>	<b>6.46%</b>	<b>0.88</b>	<b>9.62%</b>	<b>1.27</b>	<b>6.87%</b>	<b>0.63</b>
Invesco Convertible Securities (CNSDX)	6.28%	0.70	3.81%	0.50	9.24%	1.14	6.43%	0.49
Franklin Convertible Securities (FCSZX)	13.02%	1.31	6.68%	0.79	11.51%	1.24	6.94%	0.46
MainStay Convertible (MCNVX)	11.87%	1.00	6.50%	0.70	11.56%	1.17	6.10%	0.41
Vanguard Convertible Securities (VCVSX)	6.20%	0.72	3.47%	0.48	8.93%	1.12	5.55%	0.41
Putnam Convertible Securities (PCGYX)	8.52%	0.77	5.08%	0.56	9.89%	1.08	5.65%	0.37
Lord Abbett Convertible (LCFYX)	9.87%	0.87	4.58%	0.47	9.53%	0.99	4.68%	0.35
Calamos Convertible (CCVIX)	7.33%	0.68	3.91%	0.43	7.10%	0.77	4.34%	0.34
Fidelity Convertible Securities (FICVX)	6.87%	0.52	3.60%	0.35	9.84%	0.90	4.34%	0.22

*Analysis created by Zephyr StyleADVISOR. Manager returns supplied by Morningstar Inc.*

*For illustrative purposes only. This does not represent any Wellesley Asset Management products. The above funds may contain securities other than convertible debt such as convertible preferred shares, mandatory convertibles, preferred securities and equities. The performance data quoted here represents past performance. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost.*

*Factors that may affect performance:*

*As of June 30, 2016 the percentage of holdings in convertible bonds were: MCIFX approximately 92%, CICVX 62.6%, PCGYX 66.2%, FCSZX 95.57%, CNSDX 65.54%, VCVSX 89.4%, FCVX 46.8% as of 7/31/16, LCFYX 65.4% as of 8/31/16, and VCVSX 89.4% as of 5/31/16.*

*As of June 30, 2016 the gross expense ratio for each fund was as follows: MCIFX 0.94%, CICVX 0.88%, PCGYX 0.81%, FCSZX 0.61%, CNSDX 0.63%, FCVX 0.56%, MCNVX 0.74%, LCFYX 0.86%, and VCVSX 0.38%.*

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While the Franklin and MainStay Funds outperformed the Miller Fund over the past 3 and 5 years, we feel they've had to do so by taking more risk and therefore achieved a lower Sharpe ratio over those time periods. Going back to the Miller Fund's month-end inception of 12/31/07, its Sharpe ratio beats out the other convertible funds. This is because that time period encompasses the down market of 2008, and therefore our full-market cycle focus shows its benefit.

With equity prices at all-time highs and global uncertainty reaching a boiling point with the Brexit, refugee crisis, and a contested U.S. election, it's possible that the next down market is just around the corner. When it does eventually arrive, investors don't want to suddenly realize they've taken on much more risk in their portfolio than they previously thought. Focusing on risk-adjusted metrics like the Sharpe ratio when making decisions on mutual fund strategies may be a great way to make sure you are taking on an appropriate risk level in your portfolio and investing in strategies that suit your investment needs.

\*Major convertible mutual funds whose inception date precedes that of the Miller Convertible Bond Fund (12/31/07).

### ***Important Disclosures Pertaining to Article: Risk-Adjusted Performance and the Sharpe Ratio***

**Past performance is no guarantee of future results. This material is solely for informational purposes. The information presented herein has been developed internally and/or obtained from sources believed to be reliable; however, Wellesley Asset Management does not guarantee the accuracy, adequacy, or completeness of such information.**

**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.**

*Investors should carefully consider the investment objectives, risks, charges and expenses of the Miller Convertible Bond Fund. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 781-416-4000. The prospectus should be read carefully before investing. The Miller Convertible Bond Fund is distributed by Northern Lights Distributors, LLC, member FINRA/SIPC. Wellesley Asset Management, Inc. and Northern Lights Distributors, LLC are not affiliated entities.*

**NOT FDIC INSURED – NOT BANK GUARANTEED – MAY LOSE VALUE**

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<b>Index Descriptions:</b>		
<b>Index</b>	<b>Description</b>	<b>Source</b>
Thomson Reuters Wellesley	TRW is the Thomson Reuters Wellesley Absolute Convertible Bond Index ("TRW"). The Index is a joint venture between Thomson Reuters and Wellesley Asset Management (WAM) that was created in January 2013. Index performance for the period from February 2002 to the creation date is calculated based upon a model portfolio maintained by WAM. Index performance from inception to February 2002 is backtested performance based upon historical trading for certain accounts. TRW is intended to represent a strategy with the goals of absolute returns and outperforming both equities and fixed income over complete market cycles deploying convertible bonds. WAM has discretion over the selection of index constituents and their weighting in the index.	Thomson Reuters
Standard & Poor's 500 Total Return	A free-float capitalization-weighted index based on the common stock prices of 500 top publicly traded American companies, as determined by S&P and considered by many to be the best representation of the market.	Bloomberg data / Standard & Poor's
Bloomberg Barclays U.S. Aggregate Bond	A market capitalization-weighted index often used to represent investment grade bonds being traded in United States. The index includes Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds and a small amount of foreign bonds traded in the U.S.	Bloomberg data / Barclays
Bank of America/Merrill Lynch All Convertibles ex Mandatory (V0A0)	Represents all U.S. convertibles, excluding mandatory convertibles, small issues and bankruptcies.	Bank of America

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