Wellesley Asset Management

Convertible Bond Specialists

Wellesley Asset Management Commentary | April 2018

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First Quarter Total Return Comparison (%, through 03/31/2018):

	Q1 2018	1 Year	3 Years*	5 Years*	10 Years*	Since Inception 12/31/2007*	Since 1/1/2000*
Miller Convertible Bond Fund I (MCIFX)	0.50	6.06	4.64	7.04	6.85	6.70	N/A
TRW	0.92	7.43	6.08	8.06	7.88	7.59	8.46
Bloomberg Barclays U.S. Aggregate Bond	(1.46)	1.20	1.20	1.82	3.63	3.76	4.96
S&P 500 TR	(0.76)	13.99	10.78	13.31	9.49	8.20	5.28

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 1.45%, Class C 1.95% and Class I .95%.
See index descriptions and accompanying footnotes.
**Returns are annualized.*

Trees Don't Grow to the Sky

With the aging bull markets in both stocks and bonds, it has been hard to get investors to think about downside protection. In fact, 2017 was an unusually non-volatile year for equities despite the 21.83% return of the S&P 500. The standard deviation of returns was just .42% and there wasn't a single day where the index went up or down more than 1.9%. The VIX, an indicator of market volatility, remained at low levels trading between 10 and 12 for most of the year. With no volatility and markets moving higher, why should investors worry?

January of 2018 saw a continuation of the previous year's performance. The S&P 500 rose 5% in the first month, reaching targets that some strategists had forecast for the entire year. But just as trees don't grow to the sky, the markets corrected in the month of February. Major stock indices lost 10% over nine trading sessions as the Dow Jones Industrial Average and S&P 500 entered correction territory (a loss of 10% in value) for the first time in two years. The VIX posted its largest ever one day increase erasing many of the gains made by complacent investors who were shorting market volatility. Yields on 10-year Treasuries rose to four year highs as concerns about inflation resurfaced. March saw major stock indices rally with the Nasdaq Composite reaching an all-time high. However, concerns about technology stocks, a significant contributor to the bull market, emerged – leading stocks to close the month lower than where they were when the month began.

Trees Fall Faster Than They Grow

The recent volatility got me thinking about how down moves in markets tend to be more severe and more volatile than up moves. One of my favorite expressions is "markets go up the stairs and down the elevator shaft." Below are some recent examples to prove this point.

Everyone remembers the mortgage crisis in 2008 and the ensuing stock market selloff. Following the technology bubble of the 1990's, the S&P 500 closed at 879 in December of 2002. Stocks rallied to close the year 2007 at 1468 representing a 67% gain from the 2002 low. However, as the credit crisis progressed, stocks sold off aggressively with the S&P 500 closing the year 2008 at 903. In other words, five years of an equity bull market was wiped out in one year.

But dramatic down moves don't just happen in equity markets. In January of 2009 the price of a barrel of oil was at $43.72. As the economy rebounded from the mortgage crisis, demand for oil surged. In fact, by June of 2014, the price of oil climbed to $105.37 for a gain of 141% in a little over five years. As the fracking industry grew in the United States and more supply came to the market, the price of oil declined to $45.09 by September of 2015. Again, gains in oil that took over five years to amass, were wiped out in a little over a year.

Are fixed income investments immune from sharp downward moves in price? Absolutely not. In June of 2014, a U.S. government 10-year bond was yielding 2.53%. With the economy growing at a moderate pace and no inflation in sight, the 10-year yield declined to 1.32% by July of 2016 (bond prices move in the opposite direction from yields so in this case they rallied). In October of 2016, with the election of a Republican president and Republican control of Congress, traders believed that new pro-growth policies would be enacted in Washington. While these policies could be good for economic growth, they could also be inflationary. Taking this cue, bonds sold off sharply and by the end of 2016, the 10-year yield was at 2.44%. Gains that took a little over two years to accumulate were wiped out in less than three months.

When Trees are Falling, Investors Need a Good Insurance Policy

Most of our readers know we love the convertible bond asset class because of the potential for asymmetric returns of the instrument. Historically, when stocks have risen, convertibles have provided equity-like returns because of stock options embedded in the instrument. However, when stocks have fallen, convertibles typically have fallen less relative to equities acting somewhat like an insurance policy.

To understand how this works, we will look at an example. Let's assume ABC corp. issues a convertible bond at 100 when its stock is trading at $20. The company then creates a new product that has potential to significantly grow the business. As a result, the stock trades up to $30 and the convertible bonds trade up to 130. However, the company runs into production issues, despite large capital expenditures, and the stock trades down to $10. An investor would think the convertibles would trade down to the 70-80 range. However, in this example, the bond floor or pure bond value (the value of the convertible bond without the embedded call option) is 90 and that is where the convertible bonds trade with the stock at $10. Remember, convertible bonds are usually senior unsecured claims against a company's assets. As long as the creditworthiness of the company does not deteriorate, the convertible bond will hold its value even if the underlying stock continues to decline. In this example, it is entirely possible for ABC's stock to be trading at $5 while the convertibles mature at 100. In other words, equity investors lose 75% while convertible investors get their money back plus the interest that the bond paid.

As investors think about where we are in the market cycle (in the 9th year of an aging bull market), they may look to investing in convertible bonds. Some investors may think this is as simple as picking the best performing convertible manager over the last one, three, or five years. Just as you wouldn't pick an insurance policy based on price alone, picking a convertible manager involves more than just looking at performance in an up market.

One of the ways we manage risk at Wellesley Asset Management is by attempting to maintain an average bond price around 100 in our portfolios. In bull markets, the average price may reach 110, while in bear markets, the average price may go down to 95. By maintaining an average price around par, we believe we may be able to enjoy the asymmetric returns of convertible bonds. Convertibles trading around par are known as "balanced convertibles" because they have equity-like returns if equities rally, but they also enjoy bond-like performance in equity down markets because their prices are close to the bond floor.

Many of our competitors have a different strategy of investing in convertibles. In fact, most of our competitors have average bond prices of 140-150 in an effort to mimic the performance of the benchmark Bank of America Merrill

Lynch V0A0 Index. As you can imagine, these funds have a lot of sensitivity to underlying equity prices and, as a result, may perform well in a bull market. However, as the saying goes, “There is no such thing as a free lunch.” That is, these funds do not get their performance without taking risks which could affect their performance in a down market.

Perhaps the best way to look at the different strategies of hedging market risk with convertibles is to look at the average price in a fund as you would an insurance policy’s deductible. A fund with an average bond price of 150 is the equivalent of a high deductible insurance policy. That is to say, investors will have to endure losses of 40-50% before the bond-like protection of their convertible bond kicks in. Conversely, investors in Wellesley Asset Management’s products may only have small losses before the bond-like protection kicks in, as one would expect in a low deductible insurance policy.

The S&P 500 closed the quarter at 2640 representing nearly a 300% gain from the 2009 lows. At Wellesley Asset Management, we do not time the market nor do we claim to know where the market will trade in the future. We do invest in a strategy that allows us to participate in equity markets, should trees continue to grow to the sky. However, we also realize that the bull market in equities is very mature and market sell-offs are often more severe and happen much faster than market rallies. For this reason, we recommend a convertible fund with a low average bond price in case trees start to fall.

Index Descriptions:

Index	Description	Source
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. 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

Investors cannot directly invest in an index and unmanaged index returns do not reflect any fees, expenses or sales charges.

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.

Upside capture is a statistical measure of an investment manager's overall performance in down-markets. The down-market capture ratio is used to evaluate how well or poorly an investment manager performed relative to an index during periods when that index has dropped.

Downside capture is a statistical measure of an investment manager's overall performance in up-markets. The up-market capture ratio is used to evaluate how well an investment manager performed relative to an index during periods when that index has risen.

Beta is a measure of the volatility, or systematic risk of a security or a portfolio in comparison to the market as a whole.

Standard Deviation is a statistical measure of the historical volatility of a mutual fund or portfolio. A measure of the extent to which numbers are spread around their average. The greater the standard deviation, the greater a portfolio's volatility.

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