Limited Risk Investor™

The Ultimate Guide to Building and Preserving Your Wealth with Convertibles

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Greg Miller, Publisher
Darlene Murphy, Editor
Wellesley Investment Advisors, Inc.
20 William Street, Wellesley, MA 02481
781-416-4000 www.WellesleyInvestment.com

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Greg Miller Ranked Massachusetts' Top Advisor by *Barron's* Magazine for the Second Year in a Row

We are pleased to announce that Greg Miller of Wellesley Investment Advisors has been ranked the ***Number One Financial Advisor in Massachusetts*** in *Barron's* Magazine's March 7, 2016 publication of the Top 1,200 Financial Advisors. This is the second consecutive year that Greg has achieved the state's top ranking.

The *Barron's* Top 1,200 listing is the financial magazine's most comprehensive list of advisors from all 50 states and the District of Columbia. To be nominated, advisors must complete an extensive survey about their practice. The criteria for inclusion are total assets under management and revenue generated, as well as the overall quality of the practice.

In our home state of Massachusetts, with so many qualified financial advisors, this is quite an honor. Congratulations are due not only to Greg but to our entire team of professionals who work hard each day to ensure that our clients in every state receive the best possible service. Thank you – our clients – for making our success possible.

Why Convertibles Now

By Sean Edelman
Associate Portfolio Analyst

To put it simply, 2016 has been quite the wild ride for investors.

On May 21, 2015, the S&P 500 Index closed at a value of 2,130.82, which, as of this writing, stands as the all-time high closing valuation for the index since its inception. On February 11, 2016 the S&P 500 closed at 1,829.08, representing a (14.16%) decline from the May 2015 peak and a (10.51%) decline from the end of December. Many respected market experts and analysts said that we were entering Bear Market territory and it was only a matter of time before the S&P crossed the (20.00%) mark that designates a bear market.

Turns out the experts may have been premature in those claims. Since the low on February 11, there has been an earnings-fueled rally in the markets, with the S&P closing at 1,999.99 on Friday March 4th, representing a 9.34% increase in less than a month. However, one would be remiss to think that the markets' wild ride is behind us. The continued depression in global energy prices, heightened geopolitical tensions, the Chinese economic slowdown, and a contentious and uncertain presidential race in the USA are all still major factors that cloud the markets.

We don't know when the markets' seven year bull run will end; it could be tomorrow, it could be in five years. What we do know is that in times of uncertainty like this, the time is right to be investing in convertible bonds using our strategy. Unlike an equity portfolio which is exposed to unlimited losses in a falling market, investing in a portfolio of principal protected convertible bonds means at worst (barring a default) receiving principal back when the bonds mature. When equity prices are falling, convertible bonds tend to hold their value much better than the underlying stock due to their built-in principal protection.

Let's look at an example from the recent downturn:

Atlas Air Worldwide (NASDAQ: AAWW) is a global provider of outsourced aircraft and aviation operating services, operating a diversified fleet of both freighter and passenger aircraft. Due to slowdowns in global freight in the latter half of 2015, AAWW's stock price has steadily declined after reaching highs in May 2015. On May 27, 2015, the day the company issued its 2.25% convertible bond due in 2022, AAWW stock closed at $58.05 per share. The price fell steadily from that date and bottomed out on January 15, 2016 at $33.37 per share, representing a significant decline of (42.52%).

How did the AAWW 2.25% convertible bond do during the same time period (ignoring the impact of coupon payments)? The bonds were issued at a par value of 100 on May 27, 2015. On January 15, 2016, the same bonds closed at 76.54, which is a (23.46%) decline. Still a large amount to lose, but nowhere near the greater than 40% loss that one would have experienced if they had invested in Atlas Air's stock instead of the convertible bond. Another way of looking at it is a 42% decline means the price needs to rally 72.4% before you are back at your starting value, while a 24% decline means the price needs to rally only 31.6% to get back to initial value. That is quite the difference!

Most importantly, with convertibles you have a built in promise that, barring a default, you will get your principal value of $1,000 back at maturity. With a stock there never is a guarantee that the price will ever come close to reaching those highs again. There are even some blue chip stocks, often considered the safest equity investments, that haven't come anywhere near hitting their highs from the dot-com era even after 15 years! Intel (INTC) peaked over $74 per share in late 2000 and hasn't had a high over $40 since and Yahoo! (YHOO) topped out over $118 per share in January 2000 and has only closed over $50 a handful of times since then. If you were one of the unfortunate investors to buy in when the prices were near their peaks you're still sitting around waiting for your money back.

We have long preached the merits of our convertible bond strategy across full market cycles as a way to achieve consistent investment results across both bull and bear markets. Investing in a portfolio of principal protected convertible bonds issued by companies with strong financials can be an effective strategy for long-term performance, especially in turbulent times. We believe investors in properly managed convertible bonds can rest easy at night knowing they can wait out any down market, at worst receiving their principal investment back when the bonds mature, barring no default. Equity investors don't have that safety blanket, and are instead left worrying when, or if, their stocks will recover.

Keeping the "Bond" in Convertible Portfolios

By Jim Buckham, CFA, Portfolio Manager

At Wellesley Investment Advisors we have been investing in the convertible market for twenty-five years. However, there are some convertible instruments that we have avoided despite their convertibility features. Specifically, while we do invest in convertible bonds, we will not invest in convertible preferreds or mandatory preferreds. We feel that these instruments, which are, technically speaking, equities, do not adequately protect investors' principal and leave investors exposed to potential downside risks.

Unlike convertible bonds, convertible preferreds and mandatory preferreds are junior in the capital structure. In a typical capital structure bonds are senior, preferreds are junior and non-preferred equity is even lower. At Wellesley, we like to invest in companies that have tangible assets on their balance sheets. In the event of a bankruptcy, we like the fact that we have a senior claim on those assets and we feel this helps to limit our downside.

In addition, interest on convertible and mandatory preferreds can be deferred without penalty. With convertible bonds however, coupon payments are a legal obligation and any missed interest payment triggers a default.

Similar to convertible bonds, convertible preferreds have a par value upon issuance and usually mature at the same par value. Whereas par is usually $1,000 for a convertible bond, par for a convertible preferred can be $250, $500, or $1,000. Convertible preferreds tend to have long maturity dates and some can even be perpetual, meaning there is no certain date when an investor is guaranteed to recover his or her principal. We like the certainty of knowing we will receive our principal in a shorter time horizon. We believe investing in longer dated securities exposes our investors to unfavorable moves in interest rates and introduces uncertainty about the long-term prospects of a company.

Mandatory preferreds introduce yet another level of risk that we consider unsuitable for our clients. The final value of a mandatory preferred is determined by the price of the underlying stock at maturity. Therefore, it is possible that an investor could receive less than the initial investment. For this reason, mandatory preferreds fail to meet our criteria for principal protected investments.

In our opinion, convertible bonds can be ideal because they allow investors to participate in the upside of the underlying stock while protecting the downside. Some convertible instruments do a better job at this than others. In an effort to safeguard our clients' assets, we will continue to keep convertible bonds the only convertible instrument in our portfolios.

Not All CoCos Are Created Equally

By Jim Buckham, CFA, Portfolio Manager

"Necessity is the mother of invention."
– English Proverb

In the early 1990s a common criticism by U.S. corporate management regarding the issuance of convertible debt was the fact that it would be added to the denominator of fully diluted earnings per share, thus, lowering EPS. Fast-forward about twenty years and you have European regulators faced with the dilemma of insuring that banks are adequately capitalized during market downturns. In both cases market innovators turned to contingent convertible bonds ("CoCos") as a solution to their problems. However, the U.S. version of the product differs greatly from the European version.

All contingent convertible bonds have several features including: a trigger and a conversion. The trigger is the event that needs to take place in order for the conversion to happen. The conversion determines what happens to the bond once the trigger is in effect.

In the United States. all convertible bonds have a conversion price, which is the stock price at which the bond can be converted into equity. Contingent convertible bonds have an additional threshold price that determines the convertibility of the bonds. If a bond trades through the threshold price for a set amount of time (usually twenty out of thirty trading days), then the bond is convertible into stock for a set period of time. The fact that these bonds are not immediately convertible upon issuance allows corporations to exclude the possible dilution effects of the potential conversion of those bonds from their earnings per share calculation. The net investment impact of the contingency feature is negligible as the convertible bond will usually represent the conversion value of the stock, whether it is immediately convertible or not.

The European CoCo structure is very different. It was created by regulators who didn't want to have to "bail out" banks in the event of another crisis. The only similarity to U.S. counterparts is that these CoCos allow European banks to raise Tier 1 capital without dilution effects. Whereas the U.S. version focuses on trigger events to the upside, the European version focuses on trigger events to the downside. In the European version investors are the ones who "bail in" banks should they become distressed.

European CoCos pay above market rates of interest to investors. This is because investors get none of the upside and all of the downside of the underlying company's performance. The trigger events for European CoCos include deterioration in the bank's capital levels and/or a lower price in the bank's stock. The trigger events usually force investors to convert their debt into common stock and thus give up their seniority in the capital structure when they need it most. Even worse, some of these structures are written such that a trigger event forces the debt to cease to exist. In all cases, the issuer has the right to defer or suspend interest payments without triggering a default.

At Wellesley Investment Advisors, while we do own some U.S. CoCos, **we do not invest in European CoCos** because they violate too many of our investing principals. We invest in bonds that are principal-protected; they are issued at a par value and mature at a par value. In addition, one of the components of our returns is income. We would never invest in a bond where the issuer has the right to defer or suspend coupon payments. European CoCos are usually perpetual bonds with the issuer having the right to call the bonds after a set time period. Lastly, the underlying credit (European banks) is often extremely weak. At Wellesley, we purposely keep our investment horizon short and generally invest in bonds that mature or can be put back to the issuing company within a seven-year time horizon.

Yes, We Eat Our Own Cooking

By Jim Buckham, CFA, Portfolio Manager

Most of you know the story of Wellesley Investment Advisors' co-founder, Greg Miller. In his thirties, he sold his medical imaging company and wondered how he should invest his money. Greg's grandfather invested in stocks and lost most of his money in the stock market crash of 1929. Not wanting to repeat that performance, Greg's father diversified and invested in equity mutual funds in 1973, only to see his life's savings evaporate. Early in his investing journey, Greg discovered convertible bonds and spent the next years fine-tuning his investment strategy. Learning from his father's and grandfather's mistakes, Greg developed a principal-protected strategy that relied heavily on strong fundamental analysis and the knowledge he and Darlene Murphy had developed as CPAs. With the asymmetric payout of convertible bonds, investors could participate in the upside of the equity market while protecting principal when the market turned down.

Today, Greg, Michael Miller, and the rest of the Wellesley investment team manage over $2 billion for institutional investors, high net-worth clients, and other financial advisors. One thing has remained constant over all these years: Greg still invests the majority of his own money in the strategy he devised over thirty years ago, as do Darlene Murphy and Michael Miller. In addition, many employees at Wellesley Investment Advisors also have money invested in the strategy. By being invested in our own strategy, we align our interests with our clients. In fact, we often say we wouldn't buy a convertible bond for a client that we wouldn't own ourselves because often times we do own it. The concept of company management investing alongside investors also flows through to our investment selection process. Many of the companies that we invest in have large ownership by insiders. We find that when managements have "skin in the game" they tend to be better stewards of investors' capital.

So how do funds perform when the portfolio manager has a significant stake in the portfolio he/she manages? Morningstar looked at this in a study that compared management ownership against their performance relative to their benchmark from 2009 through 2014. The study found that managers who had none of their personal wealth invested in their funds had a 35% success rate in beating their benchmarks while those who had more than $1 million of their own wealth invested in their fund had a 47% success rate. Another study by Allison Evans at the University of North Carolina, Wilmington found that portfolio managers of U.S. stock funds who had more than $100,000 invested in their own funds outperformed those who didn't by 2.6%. Furthermore, she found portfolio managers with less than $100,000 invested had a portfolio turnover rate that was 61% higher than those who had more than $100,000 invested.

Most investment professionals don't graduate from college and immediately start managing millions of dollars. They enter training programs to gain further knowledge and spend years as analysts, ultimately gaining enough experience to manage a portfolio.

So when they are finally given the opportunity to invest clients' money, one would think that given all their experience, they would want to invest their personal money as well. According to the Morningstar survey, only 1,000 fund managers have more than $1 million invested in the portfolios they run. Another 2,600 have less than $100,000 invested. And over 5,000 have no ownership invested in the funds they manage. In some cases, they are prohibited by their firms from being investors.

We remain committed to the conservative investment philosophy that has served our clients and employees well for twenty-five years. While we have no plans to expand into the restaurant business, investors can be assured that we will continue to eat our own cooking.

Darlene Murphy Speaks at the 2016 TD Ameritrade National LINC Conference

Wellesley Investment Advisors' President and Co-Founder, Darlene Murphy, was selected to speak as a panelist at the 2016 TD Ameritrade National LINC Conference held in Orlando in February.

The panel discussion, "What's Top of Mind for Advisors?" was moderated by Tricia Kasner, Managing Director, Barron's. Topics discussed were workforce diversity, managing rapid growth, succession planning, and the changing demographics of registered investment advisory firm clientele.