Limited Risk Investor™

The Ultimate Guide to Building and Preserving Your Wealth with Convertibles

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Wellesley Investment Advisors Celebrates its

and our new, expanded office space!

We are pleased to announce that we have moved to our expanded space located in the same building but on the third floor. ***Take the elevator to the third level and walk across the bridge to Suite 310***. We look forward to you visiting us soon in our new location, designed to meet the needs of our growing group of employees and to better serve our clients.

Highlights of Our First 25 Years

July 23, 2016 marks the 25th anniversary of Wellesley Investment Advisors. We are very proud of our history, the tremendous effort of our employees, and the trust and confidence our clients have placed in us over the years to grow and protect their investments.

It seems like only yesterday, in our Spring 2011 LRI, we were reviewing the highlights of our first 20 years. Below is an update of the highlights of our first 25 years.

1991: Darlene Murphy, CPA, CFP® and Greg Miller, CPA form Wellesley Investment Advisors, Inc. to serve their CPA firm clientele with convertible bond and limited risk-seeking investments.

1995: Wellesley Investment Advisors acquires portfolio management and performance reporting software.

2000: Greg and Darlene decide to sell their CPA firm and concentrate exclusively on investment management.

2003: Wellesley's assets under management (AUM) more than double to break $100 million.

2007: The Miller Convertible Fund advised by Wellesley Investment Advisors launches with approximately $4 million in AUM on December 27, 2007.

2008: For the first full year of performance, the Miller Convertible Fund Class I Shares wins the Lipper Award by ranking Number One in the Lipper Equity Fund Performance Analysis Service for the One Year Period Ending December 31, 2008. There were 71 funds in the convertible securities category and the rankings were based on returns.

2009: Wellesley Investment Advisors obtains its first institutional client, one of the world's largest banks.

2010: Michael Miller is promoted to co-manager of the Miller Convertible Fund.

2011: Wellesley Investment Advisors celebrates its 20th year in business. Assets under management exceed $1 billion and the Miller Convertible Fund has grown to over $300 million. Greg Miller CPA, CEO & Co-CIO of Wellesley Investment Advisors, is named a Top 100 Independent Advisor by *Barron's*. The firm has grown from just Greg and Darlene in 1991 to over 20 employees.

2014: Wellesley Investment Advisors breaks $2 billion in assets under management. The Miller Convertible Bond Fund breaks $500 million in AUM. Greg is named a Top 100 Independent Advisor by *Barron's* for the 4th consecutive year. Michael Miller, the firm's Co-CIO, becomes an equity owner of the firm.

2015: Greg is ranked the Number One Top Financial Advisor in Massachusetts by *Barron's*. The August 24, 2015 issue of *Barron's* does a feature story on Greg and Wellesley Investment Advisors. Wellesley launches two new 40-Act open-end mutual funds, the Miller Convertible Plus Fund and the Miller Intermediate Bond Fund.

2016: Wellesley Investment Advisors celebrates its 25th year in business. Greg is ranked the Number One Top Financial Advisor in Massachusetts by *Barron's* for the second consecutive year. He is also named a Top 100 Independent Advisor by *Barron's* for the 5th consecutive year. Dar-

lene is named a Top 100 Woman-Led Business Leader by the Boston Globe for the 3rd consecutive year. Wellesley expands its facilities and moves to the top floor of 20 William Street in the Wellesley Office Park. On July 1, 2016, the corporate name of the firm is changed to Wellesley Asset Management, Inc. to better reflect our mission and what we do. Three divisions are established: Wellesley Investment Advisors to serve our direct private clients and registered investment advisors; Wellesley Convertibles to serve wirehouses, broker dealers and banks; and Wellesley Institutional Capital to serve pensions, endowments and non-profit organizations. The firm has grown from Greg and Darlene in 1991 to over 35 employees today.

Comparing Convertible Bonds to Dividend Paying Stocks and Fixed Income

By Jim Buckham, CFA, Portfolio Manager

"A bird in the hand is worth two in the bush" – Ancient Proverb

Long time LRI readers know that at Wellesley Investment Advisors, we prefer investing in principal protected convertible bonds to other forms of investments. We like the certainty that, barring a default, we will get our principal back. In addition, if the underlying stock rises while we are holding a convertible, we could receive more than our principal at maturity.

In the meantime, many of the convertibles we invest in pay a coupon, so in essence, we are being paid to wait. While other types of income producing investments have some of these attributes, only convertible bonds have all three of these characteristics.

When a corporation reports a profit, it can do one of four things with the cash:

1. Put the money in a cash account
2. Pay a dividend to shareholders
3. Buy back shares of common stock or debt
4. Redeploy the money into the business through capital expenditures

While putting the money in a cash account may be the safest option, most shareholders would prefer the "bird in the hand" scenario of a dividend payout. Options three and four may provide short-term stock appreciation or long-term growth opportunities for the company and the "two in the bush" scenario for investors, but these options are also the riskiest from a corporate perspective. If the business environment slows down substantially and solvency becomes an issue, the company may regret having used its cash to fund short-term stock appreciation or long-term growth.

It is not surprising that many of the companies that pay dividends tend to be larger, more mature and experience slower growth rates than non-dividend paying companies. For many investors, the dividend income and the potential for capital appreciation in the stock offers the best of both worlds. But what happens when these companies fall on hard times? In an effort to conserve cash, the first course of action is often to cut the dividend. At this point, investors watching the “bird in the hand” disintegrate, will sell, potentially locking in a loss.

Fixed income debt and convertible bond debt share a few important characteristics. All debt represents a contractual obligation between a company and bondholders. Companies must make coupon and principal payments or they trigger a default. Furthermore, unless the debt is floating rate, companies cannot cut the coupon rate. Straight debt investors usually receive a higher coupon than convertible investors. However, unlike convertible investors, straight debt investors do not have the potential to participate in the company’s growth through stock appreciation.

Unlike dividend paying companies, convertible bond issuers span a range of market caps and growth rates. In addition, convertible bonds offer a contractual coupon rate and return of principal unless there is a default. Furthermore, unlike straight debt, convertible bonds offer the chance for investors to participate in the upside of the underlying equity. In short, we know of no other principal protected investment that offers investors the potential for a “bird in the hand” ***and*** “two in the bush.”

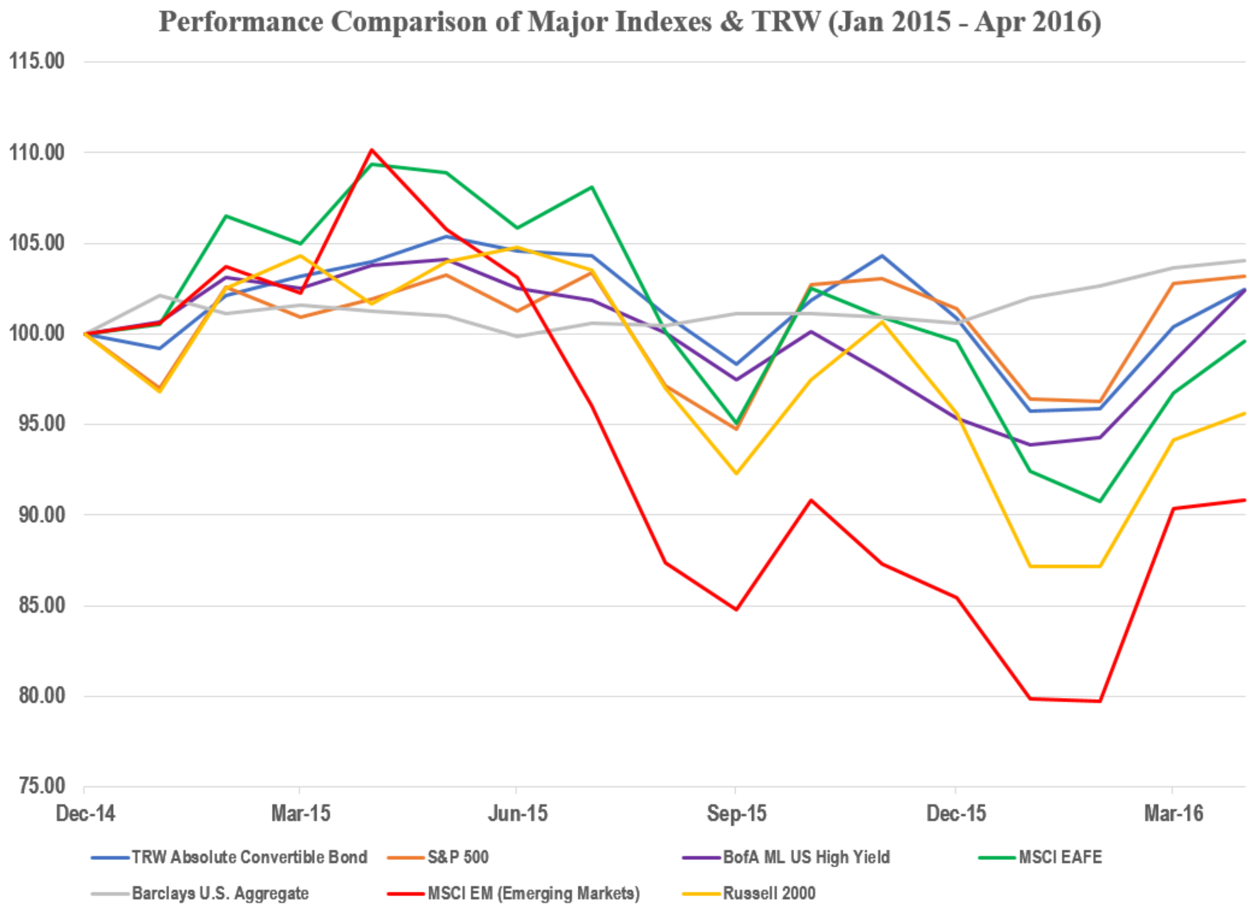
Even Some Widely Acclaimed Managers Still Have Bad Years

By Sean Edelman
Associate Portfolio Analyst

It’s no secret that it has been a frustrating situation for most investors over the past year and a half. Weak commodity prices and a tenuous global economy have led to weak performance across most major asset classes. From the beginning of 2015 through April 30, 2016, the S&P 500 returned only 3.15%, the Barclays U.S. Aggregate retuned a slightly better 4.00%, and the Russell 2000 lost 4.39%. High yield and global strategies have also struggled across the same time period, with the BofA/ML U.S. High Yield gaining only 2.39% (meaning supposed less risky investment-grade bonds outperformed domestic junk bonds), the MSCI EAFE losing 0.36%, and the MSCI Emerging Markets Index losing a substantial 9.18%.

Our principal-protected strategy was not immune from these market conditions, with the Thomson Reuters Wellesley Absolute Convertible Bond Index (TRW) returning only 2.44% over the same time period. We’ve spoken with concerned clients who are worried that they must be missing out on superior returns elsewhere. But as the graph on the next page shows, even with our strategy not performing as well as we would like, the TRW outperformed four of the six indexes mentioned above.

We have always preached our focus of delivering returns across **full market cycles** that outperform broader equities and fixed income. Markets are cyclical by nature and our full market cycle focus is an important and deliberate distinction. By definition a full market cycle includes the inevitable down portion or bear market of the cycle and we strongly believe that minimizing losses during such times is just as important as maximizing gains during bull markets. However, despite our best efforts, we can only try to minimize losses, but we cannot completely eliminate them. As much as investors don’t like to stomach losses, it is impossible (unless you only invest in risk-free money market funds) for any manager to not have years where they underperform or lose money, and even most widely acclaimed money managers are not immune to this.



Bill Gross, often known as the "Bond King", is considered one of the premier investing minds of the past few decades. As a co-founder of Pacific Investment Management Company (PIMCO) in 1971, Mr. Gross managed the firm's PIMCO Total Return Bond Fund (PTTRX) from its inception in 1987 through his departure from PIMCO in September 2014. In that time, the fund became the world's largest bond fund and its institutional-class shares (PTTRX) had an average annual return over 7.5%. Despite the strong average return and the fact that the fund is an investment-grade bond strategy, the Total Return Bond Fund still had down years under the Bond King, losing money for its investors for the years 1994, 1999, and 2013.

A lesser known all-star in the investing world is Ray Dalio, founder of Bridgewater Associates, the world's largest hedge fund company with about $154 billion in assets under management. In a 2011 feature story in *New York Magazine,* it was stated that the firm's flagship fund had an average annualized return of 18% since 1991. However, that same article also pointed out that the fund lost money in three of those twenty years. In addition, according to *Forbes*, Bridgewater's Pure Alpha hedge fund was down a whopping 6.75% through the first three months of 2016.

Did those years of losses posted by Mr. Gross and Mr. Dalio mean that they had lost their abilities to effectively manage money for their clients? Absolutely not. Most of their investors were not jumping ship after one year of inferior performance, having the confidence that short-term underperformance did not mean the strategy would suddenly lose its long-term advantages.

The same facts hold true for our principal-protected convertible bond strategy. Focusing on short-term performance when you believe that there isn't a better place to put your money, is an easy way to second guess sound investment decisions and experience inferior returns over the long term. Going back to 1/1/2000 (the inception for our TRW Index), our TRW strategy has outperformed **every single one of the indexes** listed in the first paragraph of this article while having the lowest standard deviation of monthly returns outside of the Barclays U.S. Aggregate:

Index Name	Annualized Total Return	Standard Deviation
TRW Absolute Convertible Bond	8.27%	9.13%
S&P 500	4.09%	15.12%
Barclays U.S. Aggregate	5.48%	3.45%
Russell 2000	6.46%	20.11%
MSCI EAFE	2.70%	17.29%
MSCI Emerging Markets	6.13%	22.73%
BofA ML U.S. High Yield	6.84%	9.75%

We understand as an investor it can be hard to stomach short-term underperformance. But overly focusing on small windows of performance can often mean unnecessary stress and potential for making rash investment decisions that lead to long-term underperformance. While they may see short-term fluctuations in returns, investors in portfolios deploying the TRW strategy can rest easy at night knowing that they have a full market-cycle strategy that provides principal protection in a down market and the potential for equity-like returns in an up market.

Mind the (Non) GAAP

By Jim Buckham, CFA, Portfolio Manager

Riders on London's subway system hear a public service announcement when trains approach a station telling them to "mind the gap". The purpose of this announcement is to warn riders that there is a space between the train and the platform. As investors, we feel there should be a similar warning regarding the reporting of non-GAAP earnings.

The term GAAP stands for generally accepted accounting principles. Corporations report their earnings on both a GAAP and a non-GAAP basis. The difference is that when reporting non-GAAP earnings, corporations take out non-recurring items in an effort to show a more accurate depiction of the profitability of the company. As with anything, it is up to the end user as to what should be considered a non-recurring item. For many companies, GAAP earnings are the same as non-GAAP earnings. This makes it easier to determine whether to make an investment in the company. However, for others, there are large discrepancies between the two sets of numbers. When this is the case we look to the reconciliation statements located in the company's financial statements for explanations as to why certain items were excluded from GAAP earnings.

A recent Deutsche Bank survey of the largest U.S. companies found that non-GAAP earnings fell .1% in the most recent reporting period. However, when looked at on a GAAP basis, these earnings fell **13%**! Some of the non-recurring items that are causing these large discrepancies include: foreign currency fluctuations, costs associated with new store openings and recent store closings, restructuring charges, goodwill impairment, and stock-based compensation.

Many analysts feel that companies are using everything within their power to keep their company's earnings positive. As investors, it is our job to decipher whether items are truly non-recurring or whether they are signs of fundamental deterioration within a company. Some people feel that the growing disparity between GAAP and non-GAAP earnings could also be a harbinger for market weakness. A recent Barclays' study on small cap stocks found that current divergence between GAAP and non-GAAP earnings is nearing the highs last seen in the technology bubble of 2000 and the financial crisis of 2008. These previous occasions were followed by severe market corrections. The study also concludes that stocks with high GAAP to non-GAAP differentials underperform, especially during market downturns.

At Wellesley Investment Advisors we like to invest in profitable companies. Though we prefer GAAP profits, we will invest in companies with only non-GAAP profits if we think the reconciliation between the two numbers makes sense. However, we do feel that the discrepancy between the two methodologies is a reflection of earnings quality. As a result, if the discrepancy is large, we feel the earnings quality is poor and we will be less inclined to invest in the company. Though we invest in convertible bonds on the individual merits of the underlying company, we find it interesting that the current divergence between GAAP and non-GAAP earnings could be signaling that we are on the verge of a market correction. As such, just as the riders of the London subway need to be cautious, we feel that U.S. investors need to "mind the non-GAAP".

Leveraged Fixed Income Funds vs. Leveraged Convertible Funds

By Sean Edelman
Associate Portfolio Analyst

With bond yields continuing to hover close to all-time lows, it can be difficult for fixed-income investors to achieve acceptable returns on their portfolios. One easy way to boost return is to employ leverage, which is essentially borrowing money to purchase additional securities in order to increase return. However, with this potential for added return comes more risk, because if the securities lose value, the investor is liable to repay the borrowed capital, therefore increasing losses.

In the June 4, 2016 issue of *Barron's,* an article entitled "9 Closed-End Funds with Yields of Up to 10%" discussed the attractive returns of closed-end high yield bond funds that employ leverage:

"Big institutional investors, such as pension funds, are stretching in a desperate attempt to generate returns they need to meet their promises to future retirees, resorting to alternative investments, such as private equity and real estate, as well as non-U.S. equities, to earn the 7.5% they once got from staid corporate bonds, *The Wall Street Journal* reported last week.

But current returns of 10% or more can be had on selected closed-end bond funds—readily available on stock exchanges and at discounts to their underlying asset values. That's the message that Mark J. Grant, chief fixed-income strategist and managing director for capital markets at Hilltop Securities, is delivering to his institutional clients, many of whom are unfamiliar with the asset class, which should be well known to readers of this space."

While this sounds like an attractive investment idea, it ignores a potentially better one: leveraged convertible bond funds. Here's why we feel that leveraged convertible funds are the better choice:

1. Upside potential. The 10% yield that is cited above as the return for leveraged high-yield strategies is essentially the best return that an investor can achieve as high-yield corporate bonds have little upside potential beyond their yield. In contrast, a convertible bond has unlimited upside potential due to its built in optionality and therefore can mature at a value much higher than par. Combined with leverage, this means the potential for returns above what a leveraged fixed-income fund could achieve.

2. Rising interest rate environments. When interest rates rise, leveraged high-yield strategies have the potential to lose a significant amount of value due to contracting credit spreads. Convertible bonds historically have not been very interest rate sensitive, even gaining value during several rising rate environments in the past twenty years.

3. Credit quality. High-yield bonds by definition are low quality credits, meaning they are considered by the rating agencies to have a higher risk for default versus investment-grade bonds. Convertibles as an asset class are not segregated by credit quality, and a portfolio comprised of convertibles will have a mixture of investment-grade rated securities and non-investment-grade rated securities.

In closing, while there are very attractive yields to be found in investing in leveraged high-yield bond funds, we believe that a better alternative is investing in a leveraged convertible bond fund. Unlike high-yield, convertibles have unlimited upside potential, are less interest-rate sensitive, and a portfolio of convertibles will generally have higher credit quality securities.