Limited Risk Investor™

The Ultimate Guide to Building and Preserving Your Wealth with Convertibles

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IN THIS ISSUE ...

Why Dow 20,000 Makes No Difference in Your Financial Plan

On January 25, 2017 the Dow Jones Industrial Average climbed above the 20,000 level after months approaching and weeks of coming very close. According to Forbes, it was the second fastest rise in the 120 years of the DJIA. The index had closed above 19,000 on November 22, and in 42 days, it rose 1000 points.

What does this mean? Is it important, or irrelevant for investors?

One approach to this news is to consider it irrelevant – just a number. Could you feel the difference between when the DJIA was at 19,999 and 20,000? However, we are all aware of the value in "psychological price points," for example, the practice of pricing the shirt at $39.99 versus $40, and putting the house on the market at $999,000 instead of $1,000,000. Most of us can recall a significant milestone celebration, such as that 30th birthday, but can you recall your 34th? Milestones lend over-importance to otherwise random happenings.

(Continued on Page 2)

Others have already tried to attribute this new milestone (which has quickly reverted to in the 19,000s) to our recent change in leadership and proposed changes in policies that could lead to a more robust environment for American businesses. Some have likened this to "breaking the sound barrier" in finance.

The truth is, there is no real meaning to reaching a particular point on a chart.

Even if it did matter, consider these facts. "The Dow" is an often-changing index. The corporate components vary; we aren't even measuring the same companies over time. Companies that were once great but have matured are often replaced with high growth companies. For example, in 2015, Apple replaced AT&T on the index. Also, incremental points are less impressive as the denominator increases. 1,000 or even 5,000 points on the Dow isn't what it used to be. When the Dow went from about 1,000 in the early 70s to 2,000 in the late 80s, that was a *doubling*, but it took about 15 years. In the recent 42-day span when the Dow went from 19,000 to 20,000, it went up 5.2%. Fastest 1,000-point run-up, yes, but it was not the same as the 1,000 point run up 25 years ago.

What we call "the stock market" is nothing more than the intersection of supply and demand, the outcome of various buyers' and sellers' needs, desires and other emotions. You could be looking at real trends, or just happenstance.

And yet, those who sell financial news are going to talk about such things, and offer conflicting viewpoints. The cover of the January 30, 2017 issue of *Barron's* says, in very large type: "NEXT STOP DOW 30,000", with a cover article by Gene Epstein and Jack Hough asserting "…if President Donald Trump can avoid stumbling into a trade war – or a real war – there's no reason the DJIA can't exceed 30,000 by the year 2025." Now, that's a very bold prediction. Are they right? Only time will tell.

Some of us have celebrated important milestones. Let's say, for example: 50 years of marriage. Well, congratulations! It is a big deal, and hopefully your family threw a big party. But everyone knows it isn't the 50th anniversary that matters: *it's what you did over fifty years,* and that you stuck with it. Similarly, your financial plan only cares about what you do over the long run. Staying invested, as safely as possible and making progress, is what gets you there. Focusing on trends, levels of the Dow or other indicators for purposes of timing or decision making does not work over the long run. Indeed, the <u>only</u> way to be certain to <u>not</u> make profits investing is to take your portfolio off the table. Despite this recent milestone of the Dow, we firmly believe being present in the market, day in and day out, in the right way, is what gets investors to their goals. No matter where the Dow or any other index stands.

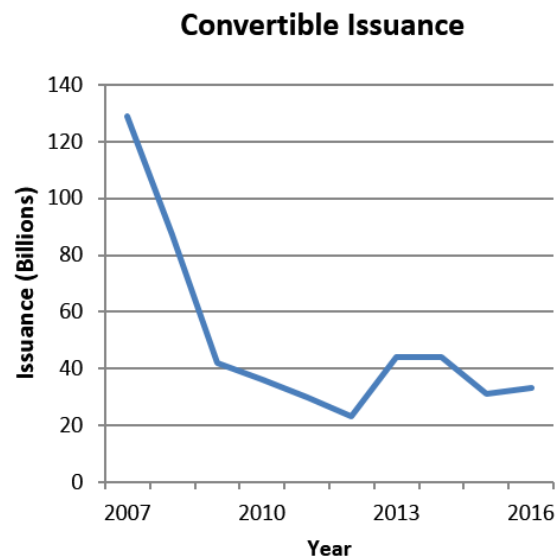
Interestingly enough, in the very same issue of *Barron's*, there is an article entitled, "Taking a Spin in Convertibles" by Amey Stone. She states: "*With stocks soaring and interest rates rising, income-focused investors should look for ways to tap into equity performance while taking less risk. Convertible securities could be just the ticket*." This made us smile, as we couldn't agree more.

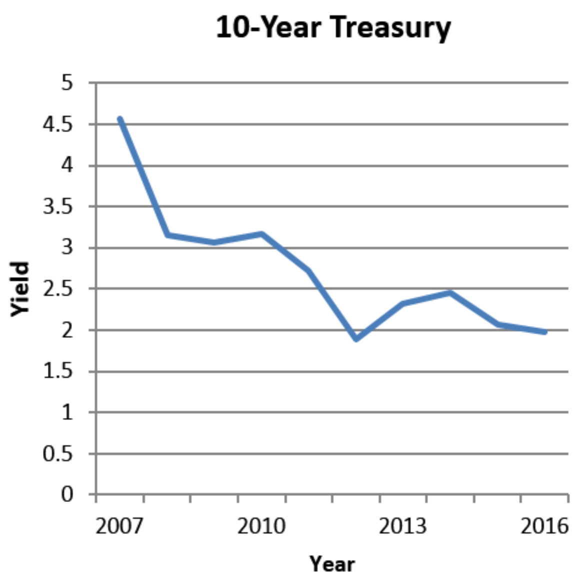
Convertible Bonds: 2017 New Issuance Outlook

By Jim Buckham, CFA, Portfolio Manager

As we begin 2017, we are optimistic about impending convertible bond new issuance for a couple of reasons. After the election, we saw equities rise as yields moved higher. This combination usually leads to higher volumes of convertible issuance as the preferred vehicle for financing. Furthermore, analysts are forecasting 2017 to be a strong year for merger and acquisition (M&A) activity. Convertibles are often part of the financing solution for acquiring companies. These effects will only partially be offset by lackluster deal flow in the IPO market, which is an important pipeline for future convertible deals.

In November 2016, we saw equities rise over 6.5% and the yield on the 10-year Treasury rise over 60 basis points, representing a 33% increase. Many feel that the new administration may pursue expansionary fiscal policy while reigning in restrictive regulations. The stock market reacted positively to the possibility of a more business-friendly environment, while the bond market reacted to the threat of future inflation. The following chart shows a 10-year history of new convertible issuance compared to the average annual rate of the 10-year Treasury*. As you can see there is a strong pattern of lower rates leading to lower levels of new issuance. As rates fall, corporations opt to issue straight debt over convertible debt. We feel that as rates rise, the opposite will be true and corporations will return to the convertible market as a means of financing. Furthermore, with equities trading within striking distance of all-time highs, the argument





for issuing convertible debt is even more compelling.

According to Dealogic, there were $3.7 trillion of takeovers announced globally in 2016. Though this represented a 15% decline from the previous year, 2016 was still the third most active year for M&A activity. With a new administration promising a more business-friendly environment, the level of deal activity could increase. Often, acquirers finance takeovers with several tranches of debt, including convertibles. Increased M&A

activity could be another source of convertible supply in the coming years.

2016 wasn't so kind to the IPO market. For the first time since 2009, there was more issuance of new convertible debt than there was of companies going public with stock offerings. Only $24 billion was raised by companies going public last year. Usually, bull markets in stocks are accompanied by a robust IPO market. But given the regulatory environment, and the vast availability of cheap financing from private equity and venture capital firms, companies are opting to bypass the equity market altogether. We are seeing companies holding off as long as they can before they go public. Ultimately, this affects convertible bond issuance because some corporations issue convertibles shortly after going public. However, many believe that if the regulatory environment loosens up, we may see more equity IPOs in the near future, which in turn should produce more convertible bond issuance.

Of course, if interest rates were to climb, convertible issuance would likely increase as well, as convertibles represent a "cheaper" corporate financing alternative.

New issuance is important to the convertible bond market because it expands the investable universe. It helps to offset bonds that are put or called, that are maturing, or that cease to exist due to a cash takeover. The new issuance market continues to be dominated by 144A bonds, bonds which can only be bought by qualified institutional advisors. In 2016, two-thirds of the issuance came with the 144A restriction. This continues to be an advantage for our 144A clients, including our mutual funds. The New Year is off to a good start for us with a new deal announced on the first day of trading – something we can't recall seeing in our 20-plus years of convertible experience. Hopefully, this is a sign that the new deal market will be robust in 2017.

**Average rate calculated as the midpoint between the high and the low of the year.*

Hypothetical Doomsday Scenario:

What would happen to convertible bonds if the stock market crashed <u>and</u> interest rates continue to rise?

By Sean Edelman
Associate Portfolio Analyst

Recently, while speaking at a conference, an advisor asked our CEO and Co-Chief Investment Officer, Greg Miller, this very question. It was somewhat puzzling, as logic and history tells us this scenario is extremely unlikely. Untimely interest rate hikes by the Federal Reserve can be a catalyst for a stock market correction, and rising interest rates can lead to short-term declines in the stock market. However, when the stock market crashes, there is usually a resulting flight to safety. Investors sell stocks to purchase bonds, which causes bond prices to rise and interest on bonds (current yields) to drop.

In the crash of 2008, the S&P 500 lost over 50% of its value between November 2007 and February 2009. Across the same timeframe, and not surprisingly, the Bloomberg Barclays U.S. Aggregate Bond Index rose 4.53% as investors flocked towards the safety of high-rated bonds causing them to rise in price. Bond math dictates that when bonds rise in value, their interest rate drops.

Here is a little primer on bond interest in case you have never fully understood it.

Every bond has a stated coupon rate of interest. That means, if a $1,000 bond has a coupon rate of 5%, it will pay you $50 per year, guaranteed (so long as the issuer is in business and doesn't default). If you obtained that bond at a cost of $1,000, then everything is very straightforward. Change the scenario a little bit and buy that same bond for $750 and suddenly your effective rate (more technically: current yield), has shot up. You get $50 and paid $750. That's 6.7%.

Likewise, if the price of that same bond rises, your effective interest rate goes down. Pay $1,100 for it, and your rate slides to 4.55%. So, we know that all bond prices and interest rates tend to have this inverse relationship. In the 2008 event, the 10-year U.S. Treasury rate fell from 4.36% on November 1, 2007 to 2.08% on December 18, 2008, a significant drop of 228 basis points in thirteen months. As expected, interest rates on bonds fell and bond prices in general rose.

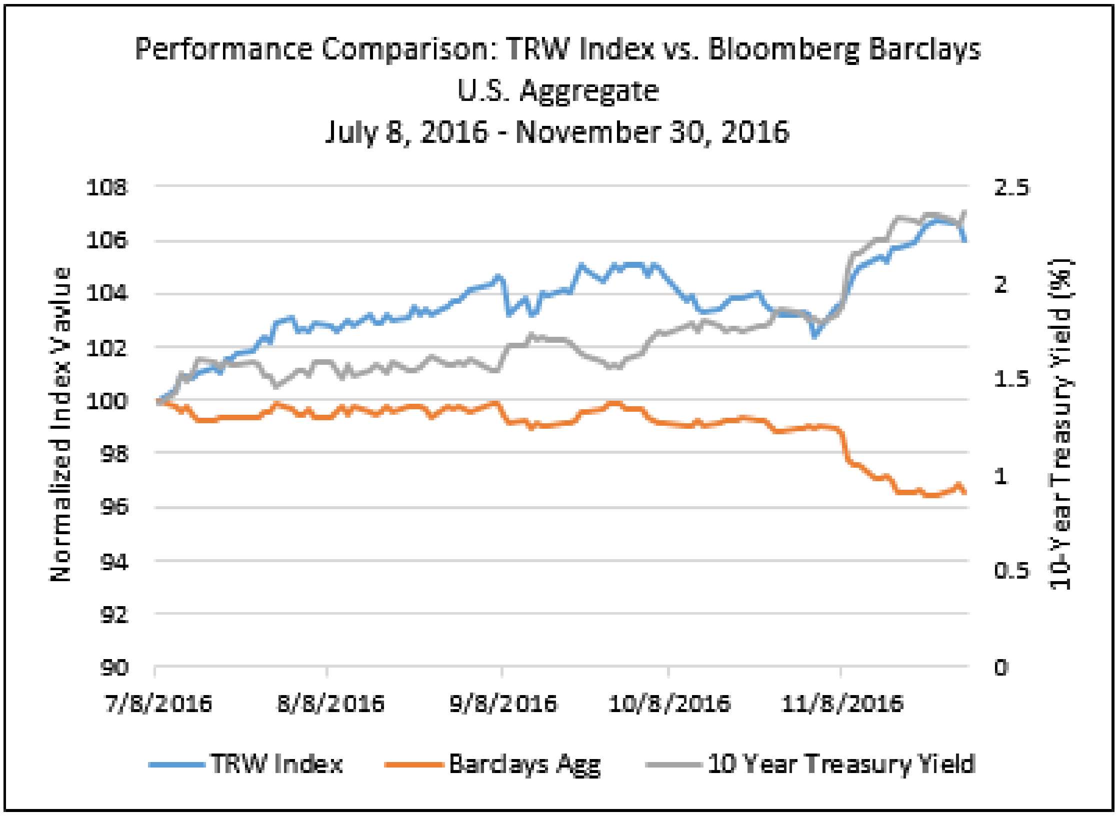
Could stocks and bonds fall at the same time? As we learned in 2008 and in other corrections, "Black Swan" events can happen. There are ways that the "doomsday scenario" could occur. For example, drastic changes in political or economic policy could lead to a situation where U.S. bonds are no longer considered extremely safe investments. When the stock market crashes, the "flight to safety" could land instead on another country's debt, possibly leading to rising rates on Treasuries and other U.S. bonds, as their prices drop. This is very unlikely to ever occur, but let's walk through how convertible bonds would be expected to fare in such a hypothetical environment.

Unlike traditional fixed-income securities, convertible bonds tend to be less exposed to interest rate risk and have historically performed well during rising rate periods. This has been evident in the current investing environment – the graph on the next page shows how our TRW strategy has fared against the Bloomberg Barclays U.S. Aggregate Bond Index since the 10-year rate bottomed out on July 8, 2016.

Despite the 10-year rate rising about 1% since July, our TRW strategy increased almost 6% during the same time period. Meanwhile, traditional bonds fell over 3.5%. Convertible bonds may be a fixed-income investment, but due to their underlying optionality, they do not have nearly the interest-rate exposure of traditional bonds. In our hypothetical "doomsday scenario" we probably wouldn't worry too much about the rising interest rate component.

So how about the equity component? If the stock market is plummeting, would convertibles still be a safer place to be, considering their exposure to their underlying equities? The answer is yes, as convertible bonds are principally protected and (barring a default) you will receive principal back when the bonds reach a maturity or put date. This means that when equity prices are falling, convertible bonds hold their value much better than their underlying stock due to their built-in principal protection. In the crash of 2008 referenced above, the TRW Index did drop, but only 17.21% from November 2007 to February 2009, while the S&P 500 dropped over 50%.

We believe our convertible bond strategy is one that works for all types of market cycles. Even if the unlikely pairing of an equity crash with a spike in rates ever comes to fruition, we think being invested in a portfolio of principal-protected convertible bonds issued by companies with strong financials gives investors a good possible solution.



Wellesley Asset Management Celebrates 25 Years – Oh What a Night!

As Frankie Valli and the Four Seasons once sang – OH WHAT A NIGHT! – perfect words to describe our 25th anniversary celebration held on Saturday, October 15th at the John F. Kennedy Presidential Library and Museum.

When guests arrived they were carried back in time by two vintage cars inviting them for a test drive – or at least that great memorable photo. Inside, the museum provided an impressive venue for guests to mingle, and view an enchanting piece of history, for some for the first time. A lively cocktail reception was followed by dinner and entertainment.

As we dined, we were treated to an entertaining surprise in the form of "The Three Waiters." The trio first masqueraded as waiters in uniform, amusing the audience with timid attempts at wit and singing. They then pleasantly surprised everyone when they revealed themselves as "The Three Tenors," performing tunes ranging from Elvis to Pavarotti in unforgettable tenor voices.

Comedian Jay Leno provided the headline entertainment after brief remarks from Greg Miller and Darlene Murphy. The audience was captivated and laughter abounded as Jay shared his unforgettable comedic talent. Following Jay Leno, the band fired up and the dance floor came to life.

Through it all, we thoroughly enjoyed ourselves and especially enjoyed getting a chance to chat and reconnect with so many clients in a social setting. Thank you to all who were able to join us and here's to the next 25 years!

Important Disclosures:

Past performance is no guarantee of future results. All investments, including convertible bonds, have a risk of loss.

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TRW is the Thomson Reuters Wellesley Absolute Convertible Bond index ("TRW"). The Index is a joint venture between Thomson Reuters and Wellesley Asset Management 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 Wellesley. 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. Wellesley has discretion over the selection of index constituents and their weighting in the index.

The S&P 500 Total Return Index is a cap-weighted index of 500 common stocks regarded as a leading proxy for the U.S. stock markets. Index returns assume reinvestment of all distributions and do not reflect the effect of fees, transaction costs or taxes. A direct investment in an index is not possible. Bloomberg Barclays U.S. Aggregate Bond Index is 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 U.S. The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

Indices do not reflect the costs of trading, management fees or other expenses. It is not possible to invest directly in an index. Wellesley Asset Management accounts differ from an index in that they are actively managed and may include substantially fewer and different securities than those comprising an index. Exposure to an asset class represented by an index is available through investable instruments based on the index.

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