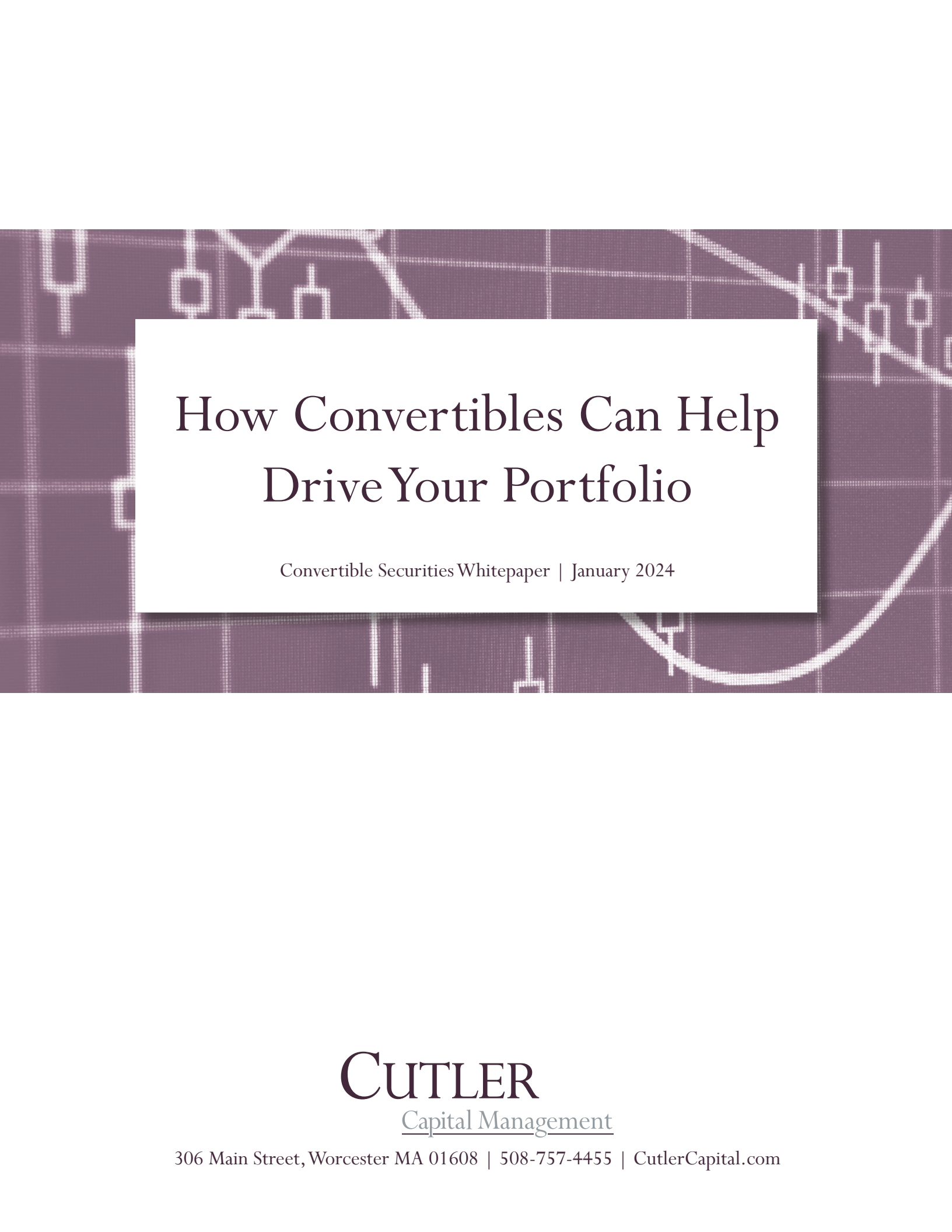




How Convertibles Can Help Drive Your Portfolio

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Capital Management

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They Can Really Do All That?

One of the early episodes of Saturday Night Live featured a commercial for an imaginary product called Shimmer. Dan Aykroyd insisted it was a dessert topping while the late Gilda Radner, playing his wife, said Shimmer was a floor wax. Then the announcer, played by Chevy Chase, stepped in to explain that Shimmer was both—a floor wax and a dessert topping. It made things especially convenient when Aykroyd inadvertently sprayed some of his pudding’s topping on the floor.

Convertibles And The Three Essential Properties

Convertible bonds aren’t quite as versatile as Shimmer, but in their own way, they are not far behind. Investors can use them. Just as Shimmer satisfied two of the main household needs, convertibles can fulfill the three primary goals most investors have. After all, most people want their money to generate some blend of **(1) capital preservation, (2) current income, and (3) appreciation potential**.

When you think about it, very few individual investments offer all three. Stocks can give you appreciation and dividend income. Some are safer than others—at Cutler we like community banks because we buy them at small premiums to their tangible equity value. But no stock can structurally offer capital preservation, since they all have potentially infinite lifespans.

Convertibles are one of the few exceptions. For a rule of thumb, convertibles provide about two-thirds of the upside of stocks, though this can vary significantly depending on the price and terms of the issue. You can’t get that from regular bonds. But convertibles also provide income—usually less than traditional bonds, but more than stocks, especially given that many convertible issuers do not pay dividends. And most importantly, they have considerably better downside protection than stocks. The rule of the other thumb is that convertibles typically only experience one-third of the downside of stocks over time. It’s often even less—usually no downside at all if you hold to maturity.

Unique Risk/Reward Profile¹

Convertibles are, as the name suggests, securities that can be converted into something else. Most convertibles are bonds, interest-paying pieces of paper that can be turned into the stock of the interest-paying company. A few convertible bonds don’t pay cash interest but are still valuable because, like all bonds, they promise the return of principal at maturity.

Convertibles become most valuable when the underlying stock rises substantially, making them worth more as stock than as bonds. The most important thing, though, is that even when the stock doesn’t perform to expectations, patient convertible holders can benefit from either holding the bond to maturity or holding long enough to get a significant turnaround in the underlying shares. This favorable risk/reward profile has led to outstanding returns from convertibles relative to their stock and bond cousins, as the chart below shows.

Convertibles Performance vs Equity and Bond Indices

(Cumulative total return through 12/31/2023)

Asset Class ²	Index	One Year	Three Years	Five Years	Ten Years
Convertibles	BAML All US Convertibles Index (VXA0)	13.0 %	-2.4 %	75.8 %	134.3 %
Large Cap Equity	S&P 500 Total Return Index (SPX)	26.3 %	33.0 %	107.0 %	210.9 %
Small Cap Equity	Russell 2000 Total Return Index (RTY)	16.9 %	6.7 %	60.6 %	99.1 %
Fixed Income	Bloomberg Barclays US Aggregate Bond Index (LBUSTRIU)	5.5 %	-9.6 %	5.6 %	19.6 %

Source: Bloomberg

Convertibles: Highly Competitive Returns with Lowered Volatility Over 20+ Years

(Annualized from 12/30/1994 to 12/31/2023)

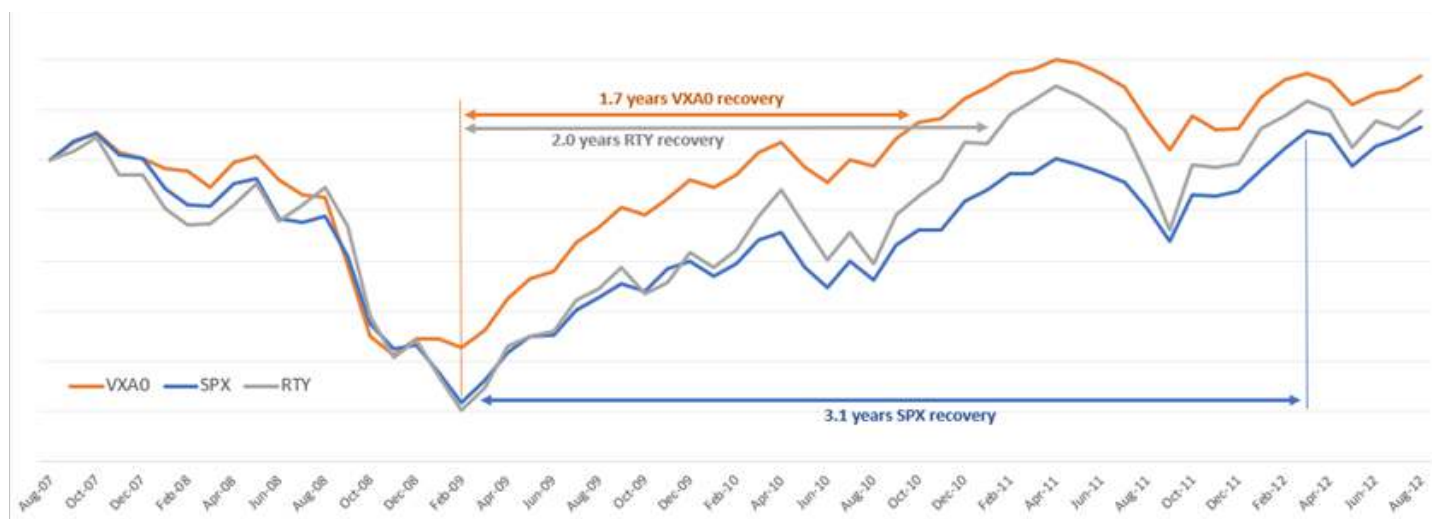
Asset Class	Index	Annualized Return	Standard Deviation	Sharpe Ratio
Convertibles	BAML All US Convertibles Index (VXA0)	10.0 %	12.8 %	0.46
Large Cap Equity	S&P 500 Total Return Index (SPX)	11.6 %	15.3 %	0.49
Small Cap Equity	Russell 2000 Total Return Index (RTY)	9.9 %	20.1 %	0.35
Fixed Income	Bloomberg Barclays US Aggregate Bond Index (LBUSTRUU)	5.2 %	4.1 %	0.09

Source: Bloomberg

Note in the performance shown above, convertibles have participated in about 95% of the upside of large-cap stocks while actually exceeding that of small-cap stocks. They accomplished the latter with less than two-thirds of small-cap volatility. This is noteworthy because convertibles are usually, though not always, issued by smaller-cap companies. Many market observers think it is more appropriate to measure convertibles against the Russell 2000 than the S&P 500. Some investors, indeed, like to use convertibles as a small-cap substitute, a practice we endorse.

Perhaps most compellingly, it took convertibles only about half as long as large-cap stocks to recover from the depths of the global financial crisis, as the chart below shows. Small caps, being closer to convertibles, bounced back more quickly than large caps. So even though large caps have generally outperformed other equity and equity-like securities during the most recent bull market, convertibles have shown resilience while providing competitive-to-exceptional returns.

Convertibles (VXA0), Large Cap (SPX) and Small Cap (RTY) Recovery From Financial Crisis Low



Source: Bloomberg

The Three Main Groups Of Convertible Investors³

The first group, to which most convertible investors belong, looks to take advantage of the favorable asymmetry of newly issued convertible bonds or other bonds trading within 10-15% of their issue price, either above or below. These “balanced” investors know they can expect to receive the bond’s current income and 100 cents on the dollar if the company remains solvent through the bond’s maturity, but also that if the underlying stock performs strongly, they have the potential for larger gains. (Of course, once the convertible price has risen significantly, the investor must decide whether to lock in the gains by

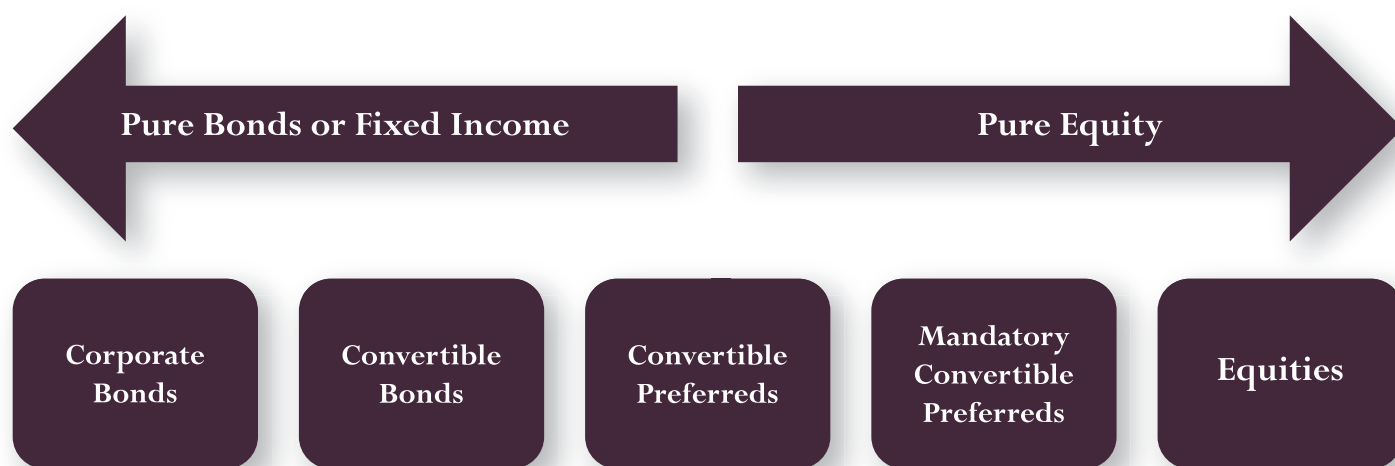
selling or hedging, or to hold on in hope of further gains).

The second group buys convertibles primarily for yield. Because convertibles are usually issued with relatively low coupons, yield investors make most of their money in convertibles (sometimes known as “busted”) trading at significant discounts to par value, such as bonds trading around 75 or 80 cents on the dollar⁴.

Hedge funds represent the third group. Most of them buy convertibles while selling short enough of the underlying shares to have a theoretically neutral position. In other words, they set up positions that should make on the short stock what they lose in the convertibles on down days, with the opposite taking place on up days. Hedge funds also often hedge other risk elements, most notably the interest-rate and credit risks of convertibles, and they also frequently sell options to generate income and offset the tendency of certain convertibles to lose some value as time passes⁵.

Types Of Convertibles

There are a few different types of convertible securities, with characteristics ranging from “Equity-like” to “Bond-like”.



As we noted earlier, most convertibles are bonds (or, as they are often more properly called when maturing in 10 years or less, notes). For simplicity we’ll just call them bonds. Like traditional bonds, convertible bonds pay regular interest (although a few are zero coupons), usually semiannually, and mature at a specified date, most commonly five or seven years after issuance. This finite lifespan gives convertible bonds considerable price support over extended periods. That said, because they are somewhat less liquid than stocks, convertibles may trade down more sharply in near-term selloffs than their merits would typically justify. This creates opportunities, especially for the yield-oriented investors described above. Traditional convertible preferred stocks, which decades ago were an important part of the convertible market, now occupy a very small region—probably well under 5%. Preferreds generally have less appeal to issuers, since dividend payments are not always deductible, and to investors, because their often infinite lifespan and lower seniority makes their price support more tenuous. Nevertheless, some financial institutions still like to issue convertible preferred as a way of raising equity capital demanded by bank regulators.

Replacing traditional preferred stocks over the last 25 years or so has been a relatively newfangled structure known as a mandatory convertible preferred. As the name implies, mandatories differ from traditional convertibles in that holders are required to convert into common stock at the end of the security’s life, usually three years from issuance. Remember that convertible bonds, absent bankruptcy, promise to repay investors their par value (100), usually the issue price, at maturity. The mandatory nature of this conversion feature means these securities will be highly equity-sensitive, allowing for capture of most of the upside in a common stock while generating substantially greater current income.

Mandatories, unlike traditional convertibles, must be turned into shares at a ratio that depends on how the stock has performed. In general, mandatories provide about 80% of the underlying shares' upside. The main protection from mandatories simply comes from the fact that they pay significantly higher dividends during their lives than do their underlying shares.

You Don't Need To Wait For The Stock To Exceed The Conversion Price

When a convertible bond is issued with a 35% conversion premium, it means that at maturity, the stock must have risen more than 35% for the convertible to be worth more than its redemption (par) value.

It does NOT mean that the securities will not appreciate during their trading lives until those upper levels are breached. On the contrary, if a stock rises by 35% during the first year of a convertible bond's life, the convertible bond will likely rise by somewhere in the 20%-25% range if not more. You will often hear the term "delta", one of the Greek letters traders like to kick around, to describe the ratio of one security's performance to another's. As we noted earlier, a typical convertible might have a delta of about two-thirds, or 67%, though this will of course vary with a variety of factors, especially the underlying stock's performance and the time until the convertible matures⁶.

To put it simply, don't worry. In most cases, if you buy a reasonably priced convertible, when the underlying stock goes up, your convertible will go up as well, even if not by as much.

Managing A Convertible Portfolio

When our team agrees that a new convertible is worth purchasing, we decide whether to set a firm limit price or to give a market order, recognizing that at times it may not be worth missing out on an attractive long-term position for a quarter of a point. But when an issue is highly liquid, particularly when we know one or more larger sellers are in the market, we believe we can improve investor returns by entering the position on our own terms.

Some in the convertible community jokingly refer to issuers that come back to the market years (sometimes months) after their first convertible deal as "repeat offenders." Call them what you will, returning issuers are a critical part of the marketplace⁷. We often take the opportunity to swap out of a company's appreciated convertible into a newly issued, lower-price one with a more favorable risk/reward profile.

The Cutler Approach

At Cutler, our convertible team members average 20 years of experience. We look to exploit all the benefits of convertibles, focusing on issues that both offer yields competitive with non-convertible securities and have meaningful potential upside. These can be bonds, traditional preferreds or mandatories. But even as we look for yield and upside, capital preservation is always very much part of our investment process.

When we invest in convertible bonds, we typically look to buy bonds in the "sweet spot" near par, where we get the best ratio of potential upside to potential downside. When we buy mandatory convertibles, we focus on high-yielding securities where we have a high degree of confidence that we are effectively buying the underlying stock at or near what we consider its intrinsic value.

The Silver Screens

There are hundreds upon hundreds of convertible securities. Only a relative few meet our criteria of yield, upside, safety and valuation. So we begin by screening the convertible universe and pulling out those candidates offering, at least at first glance, the quantitative properties we seek. Specifically, we eliminate securities that have not been registered with the SEC and (in most cases) those with negative yields, as well as securities that may not be appropriate for other reasons for our specific investors. We also use a proprietary rating system that highlights convertibles with some of the best risk/reward profiles. Within the convertible universe are numerous types of opportunities for those that know where, and how, to find them. We

generally use 10-12 different screens to find the right securities for our partnerships and separate accounts. Some of our classifications are by type (bonds vs. preferreds and mandatory preferreds); by profile (yield-oriented versus balanced, equity-sensitive or cash-alternative); and by credit quality (investment-grade or lower). We also look for convertibles we consider particularly valuable because of how they are designed to protect investors from increases in the underlying stock's dividend. (Higher common dividends tend to reduce the value of convertibles because they can reduce the convertible's yield advantage while also shrinking the company's growth capital).

Putting It All Together

Having run these various screens, we investigate the liquidity profiles of the convertibles that are still standing. No matter how attractive a convertible might appear, if you can't actually buy it at or near the quoted price, it's usually wise to stay away. But if an issue passes liquidity muster, we go to work, compiling an in-depth file on the issuer and the convertible. The file includes credit and equity profiles, featuring data and news from Bloomberg and other leading sources, analyst reports, company filings, and conference-call transcripts. We create detailed pictures of the convertibles, complete with valuations and risk/reward analyses.

We evaluate our positions regularly and will informally get together and decide it's time to get out if a name isn't acting the way it should. The formal conversations, the really tough ones, happen when a company's fundamentals are deteriorating and our investment rationale is tested. We are not active traders, but we are fully prepared to exit a position, even if it's behaving well, if we think there's a better alternative, whether from the same issuer or another one. Along the way we run stress tests, evaluating where we think a convertible will trade under a variety of scenarios. This helps keep us from getting caught flat-footed. We like to think of ourselves as the baseball player who tells himself before every play, "the ball's coming to me, the ball's coming to me." When it's time to act, we're ready.

About Cutler Capital Management

Cutler Capital Management is an independent, registered investment advisor. We are a 100% employee-owned firm dedicated to the management of under researched, underutilized investment opportunities. We specialize in Convertible and equity-linked securities, Community Bank investments, and Real Estate Investment Trusts. We add value through our rigorous research process, using a bottom-up approach that starts with a proprietary screen to generate ideas, followed by detailed structural, credit and fundamental analysis. We exploit being a niche player in inefficient markets.

We offer our investment strategies to high net worth individuals, endowments, foundations, corporate pensions and family offices through Limited Partnerships and Separately Managed Accounts. Our Wealth Management offering, serving high net worth individuals, includes comprehensive financial planning and investment management.

ENDNOTES

¹ While the data in this section are representative of past convertible performance, in general, convertibles have less upside than equities because of their conversion premiums and more downside than traditional bonds because of their lower coupons and often lower credit quality.

² The BAML All US Convertibles Index (VXAO) tracks the performance of the publicly issued U.S. dollar denominated convertible securities of U.S. companies. The S&P 500 Total Return Index (SPX) is a market-cap weighted equity index of 500 large companies in the U.S. and is regarded as a leading proxy for the U.S. stock market. The Russell 2000 Total Return Index (RTY) is comprised of the bottom 2,000 stocks in the Russell 3000 index, and is the most common benchmark of the U.S. small capstock market. The Bloomberg Barclays US Aggregate Bond Index (LBUSTRUU) is a broad-based index that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market and is a commonly used benchmark for the broad investment grade market. Investors cannot invest in an index and references to index returns do not reflect the performance of any actual investment. Index returns do not reflect the deduction of advisory fees or other trading expenses. Past returns are not necessarily indicative of future performance and these data do not constitute a recommendation.

³ Investors typically describe convertibles by referring to two properties: their yield and their conversion premium. You can think of this as what you get (yield) versus what you give up (premium). Convertibles that generate more income typically offer less upside potential. Most investors know yield—it can be either the current yield, dividing the income by the market price, or more properly the yield to maturity. The former is more appropriate for convertibles on stocks that have risen substantially, while the latter applies better to newly issued convertibles and bonds whose stocks have been flattish or down after the convertible's issuance.

The premium represents the amount by which the convertible's market price exceeds the value an investor would receive by converting into stock right now. Investors pay this premium for the assurance that even if the stock doesn't do well, they can still expect to receive the bond's par value (usually 100) at maturity. On newly issued convertibles, this premium usually ranges from 20% to 40% depending on a variety of factors. The higher the premium, the less the convertible will participate in the growth of the underlying stock. The reason: when a stock rises substantially, this premium approaches zero. In other words, convertibles become stock substitutes when the stock performs exceptionally well.

⁴ The majority of the yield often comes from accretion, also known as "pull to par." For instance, a five-year bond with a 3% coupon, trading at 80 cents on the dollar, would have an 8% yield to maturity. Investors who buy these bonds typically wait for a stock to drop precipitously, which brings the price of the convertible down to a level where the yield is acceptable. These investors are known for doing in-depth credit analysis, for building large positions once they become convinced of an issue's attractiveness, and selling convertibles after the stock has sufficiently recovered to bring the convertible's price back around par (100) or higher, where the yield has come down to approximately the coupon.

⁵ These hedging techniques are beyond the scope of this paper, but stated simply: hedge funds try to identify attractively valued convertibles and lock in the cheapness by hedging the core elements (stock, interest rates, credit, and optionality/volatility). They are typically drawn to convertibles whose underlying stocks have risen sharply and thus trade at small premiums to their conversion value. By purchasing these convertibles and selling short most or all of the underlying shares, hedge funds effectively set up inexpensive put options on stocks, because in a sharp downturn the bonds are likely to outperform the shares significantly.

⁶ To understand why convertibles trade with deltas, consider what would happen if this were not the case. Suppose in year one of a seven-year convertible issued with a 35% premium, the stock were to rise by 35% while the bonds did not move. That would leave the bonds trading with no conversion premium, or at "parity", with six years of life remaining. Who would buy the stock? They could just as easily buy a convertible, which could be turned into stock at the current price, but which would also offer essentially full investor protection at the current price (assuming the investor held for the next six years). Clearly, the convertible would be a much better buy. And even if the investor had to pay another 10 or 15 points, it would probably still be a much better buy. So the market drives the convertible price to a point where it has a proper risk/reward relationship with the underlying stock.

⁷ There are two reasons behind this. One is that many, perhaps most, convertible issuers start out with trepidation. They worry about the many moving parts in a convertible—the stock, the bond, the option, the accounting, the changes in conversion ratios with dividends and splits, the treatment when certain corporate events occur. It's so much easier to sell straight stocks and bonds. The trouble is that giving into fear of the unknown often means missing out on an ideal financing tool. Traditional convertible bonds let issuers pay far lower coupons than straight debt would carry while simultaneously enabling the issuers to sell stock—if they sell it at all—at a significant premium to the market price. Viewed as such, it's a win-win proposition for the capital raiser. And once a company is at ease with the asset class and the process, it's likely to come back repeatedly.

The other reason is that convertibles are shape-shifters. When the underlying stock rises, the convertible becomes a virtual stock substitute, no longer offering a favorably skewed risk/reward ratio. Investors seeking that favorable skew have to sell, or should sell, if they are sticking with the core convertible value proposition. But if these investors still like the company, they'd love to find a way to stay involved in its securities. The solution: a new convertible with a higher conversion price. And at Cutler, if we still like the company, we'll gladly swap out of its older, appreciated convertible into the newer, more balanced one. Issuers know that when their first convertible performs well, they can rely on a ready-made audience for their next one. And so forth. It's a winning outcome for issuer and investor alike, and one we've participated in frequently throughout our history.

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