The Market Humbles the Majority – Yet Convertible Bonds Provide an Attractive Tradeoff between Upside Participation and Downside Protection – Part II: Healthcare Sector[1]

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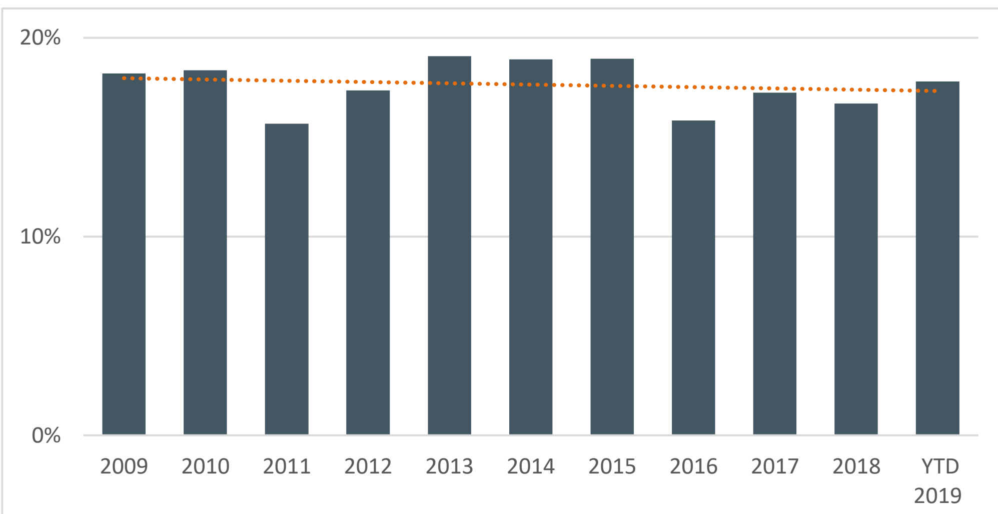
Healthcare Sector Prevalence in Convertible Bonds

This is Part II of a series of papers that shed some direct light on SSI's practical views on certain sectors and securities, as well as our approach to how we actively manage our investment portfolios. Part II includes a particular focus on the Healthcare Sector.

The Healthcare sector has historically represented a significant portion of the overall convertible bond universe (represented by the ICE BofA ML All US Convertible Index VXA0) and trading volumes, averaging a sector weight of 17.5 percent (Figure 1):

Figure 1. Healthcare Sector % Weight of Overall Convertible Universe (as of July 31, 2019)



Source: ICE BofA ML Convertible Research

The scope of companies issuing convertible bonds ranges from small cap development stage innovators to large, established conglomerates. **Amgen**, **Celgene** (featured below), and **Onyx Pharmaceuticals** are just a few examples of issuers that financed their strong growth through convertible bond issuance. Currently, **Insulet Corp**, **Exact Sciences Corp**, and **Dexcom Inc.** (also featured below) are exhibiting similar growth potential. On the large cap side of our universe, Johnson & Johnson and Anthem Inc. have been accessing our market as well, providing investors the opportunity to participate in share price appreciation while protecting capital in a downside scenario.

The Convertible Bond Asset Class

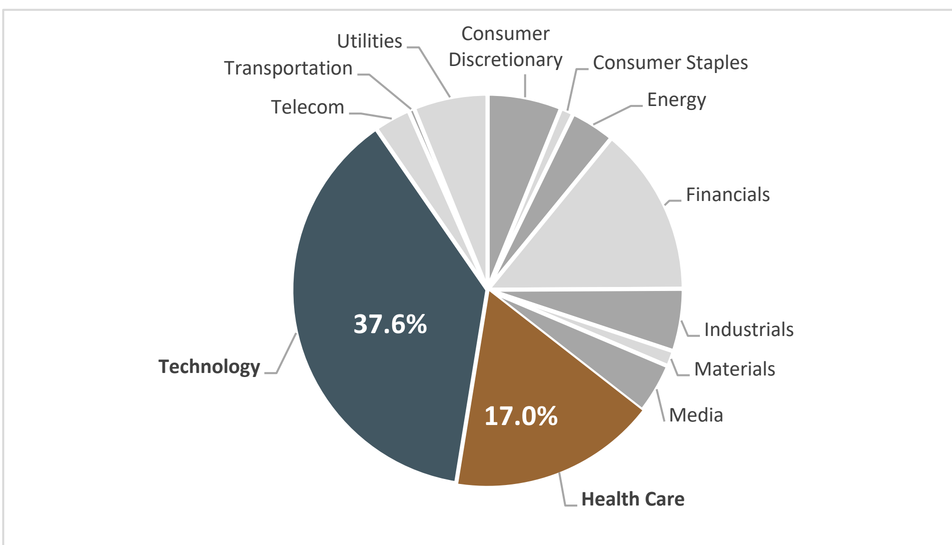
Convertible bonds are a unique asset class – they provide upside participation with the underlying equity, but also limit downside participation via the embedded bond floor. Most of our clients in this asset class use convertible bonds as a conservative equity alternative (although individual portfolios can be tailored to any investment objective – credit rating, equity sensitivity, return expectations, etc.). SSI Investment Management has been managing convertible bonds for over 30 years, generating an annualized return of 10.41% (January 1, 1983 through July 31, 2019[2]), capturing 91.3% of the S&P 500's total return at a lower volatility, resulting in a Sharpe Ratio of 0.53.

The majority of the convertible bond universe is represented by straight convertible bonds. The remaining structures include mandatory convertibles and preferred convertibles.

Sector Distribution

The Technology and Healthcare sectors have been dominating and continue to lead issuance and market value weights in this asset class. The typical convertible bond issuer is a mid- or large-cap growth company, where the convertible debt taken on is the only debt on the balance sheet. In aggregate, these two sectors make up 54.6% of the USD-denominated universe (Figure 2 as of July 31, 2019).

Figure 2. Overall Sector Distribution for Convertible Universe (VXA0)

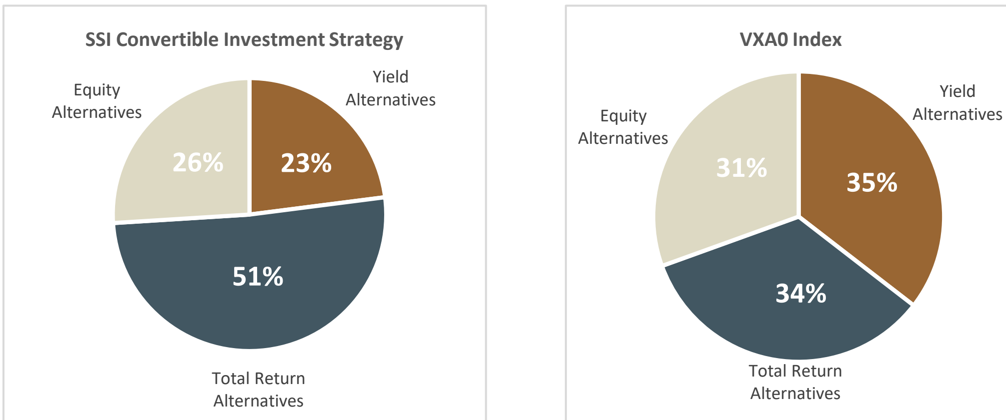


Source: Barclays Research

New Issuance

New convertible bond issuance is crucial to and constructive for our universe. It helps representation of the balanced zone – where the tradeoff between upside participation and downside protection is most optimal. For that particular reason, we are predominantly invested with an overweight in the securities of that segment of the convertible bond market (Figure 3) . Our investment process incorporates trimming or selling positions that have appreciated into the equity-like zone and redeploying the proceeds back into the convex (balanced) section of the universe.

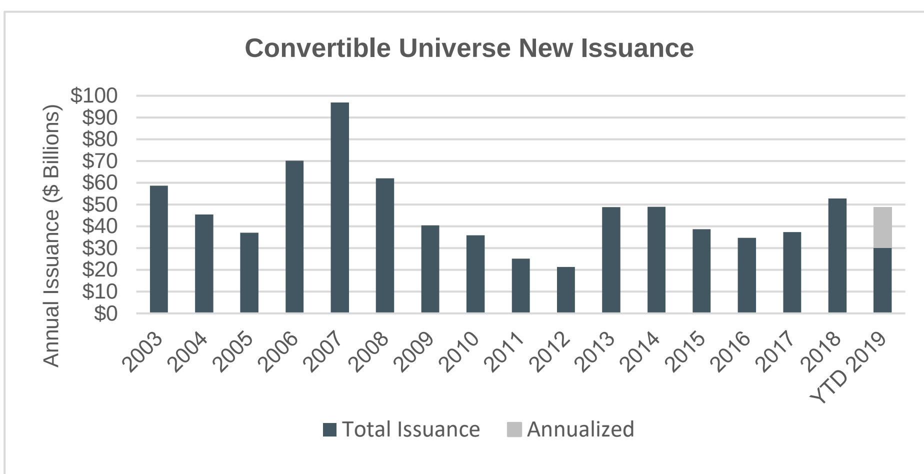
Figure 3. Delta Weights



Source: ICE BofA ML Convertible Research, SSI internal research. Above SSI statistics are from the respective Strategy's representative portfolio as of July 31, 2019.

So far in 2019 (through July 31), new convertible bond issuance has totaled $30.1 billion ($48.9 billion annualized), versus $52.8 billion in 2018. Issuance has improved steadily since the fallout from the financial crisis (Figure 4).

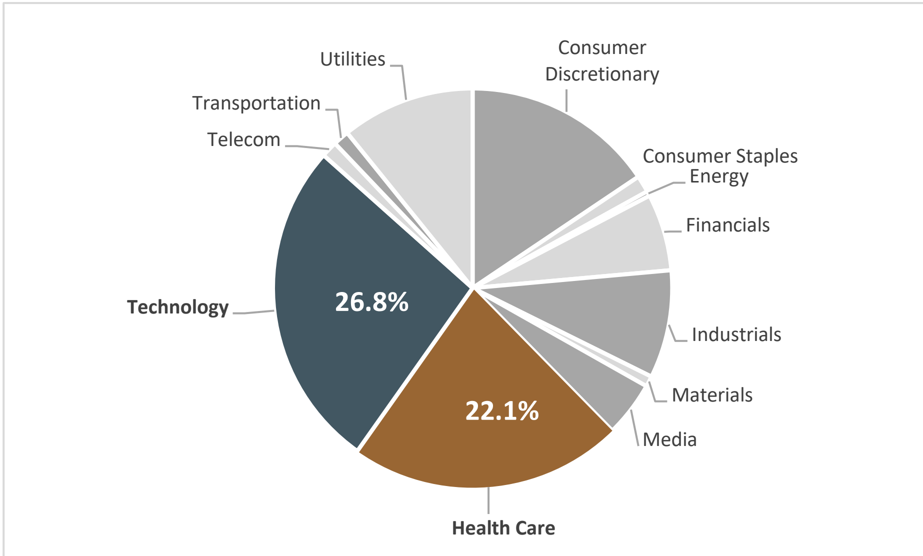
Figure 4. New Issuance by Year



Source: Barclays Research as of July 31, 2019.

The Technology & Healthcare sectors continue to lead overall new issuance:

Figure 5. New Issuance by Sector



Source: Barclays Research as of July 31, 2019.

Healthcare

> *The four most dangerous words in investing are: 'This Time It's Different'*
>
> *-Sir John Templeton*

As much as I agree with Sir Templeton's quote and investment philosophy, Healthcare is the one sector where 'this time' is actually different from cycle-to-cycle. The Healthcare sector and its constituents are exposed to more - and more meaningful - external factors than the rest of public markets. Drug development pipeline potentials change constantly, FDA new drug approval efficiency varies extensively, sometimes sadly due to understaffing at the agency, and political grandstanding creates a headline overhang for the sector as a whole at times (many times).

As recently as mid-April, Democrats launched the 'Medicare For All' campaign. It is no secret that the party is swinging far to the left in the hope of drawing votes from the Republicans. Senator Biden entering the race does at least represent the possibility of some middle ground, but that has not stopped Senator Bernie Sanders and likeminded left-wing Democrats from trying to swing those voters their way. A 'Medicare For All' single payor program might appeal to some undecided voters, but it is highly unfeasible. The marginal tax rates proposed by Senator Sanders, not very unlike the rhetoric deployed by Senator Hillary Clinton in 2015, look incredibly unreasonable in the light of Vermont's attempt to deploy a single payor system in 2011 - 2014. However, the debate around drug pricing will most likely persist into the coming election cycle and create some valuation multiple depression for a large portion of the Healthcare sector.

The convertible bond universe's issuer base includes many small companies in growth mode, especially in the Healthcare (& Technology) sectors:

Celgene

Although their convertible secruites have since matured, when **Celgene (CELG)** issued their first convertible bond in June of 2003, the biotechnology company was a development-stage small cap firm with a market cap of under $2.6 billion. Revlimid - currently approved in multiple myeloma, myelodysplastic syndromes, and mantle cell lymphoma – was still in development stage. In its debut year of 2006, the drug generated $321 million in revenue. In the trailing one-year period (through 2Q2019), Revlimid revenue was over $10.3 billion. Celgene was also successful in advancing other pipeline drugs, which account for more than $6 billion in revenue (LTM through 2Q2019). With this strong revenue growth, Celgene's market capitalization has risen to over $66 billion currently. In January of this year, the company received a buyout bid from Bristol-Myers Squibb (combination of cash & stock), currently valued at $85.3 billion.

Current portfolio highlights

Insulet (PODD) – a medical device company that develops and manufactures insulin infusion systems for diabetes patients. Insulet issued convertible bonds in 2016 and 2017. Since becoming a convertible issuer, the company's underlying stock has appreciated 182% (9/8/2016-7/31/2019).

Exact Sciences (EXAS) – a life science equipment company specializing in non-invasive molecular testing for the early detection of colorectal cancer. Exact Sciences first entered our universe in early 2018 (with a follow-on issue in 2019). Uptake of EXAS' product has been successful, and the company's stock has appreciated 109% since the first convertible bond was issued (1/11/2018-7/31/2019).

Dexcom (DXCM) – Dexcom designs and develops continuous glucose monitoring systems for people with diabetes. The company has developed a small implantable device for subcutaneous tissue glucose monitoring, which then transmits measurements to an external device. Dexcom issued its first convertible bond in mid-2017 (with a follow-on issue in late 2018). Physicians, patients, and payors have been receptive to the company's technology, resulting in stock appreciation of 114% since first issue (5/8/2017-7/31/2019).

Conclusion

While headline overhangs will likely persist through the current election cycle, Healthcare presents many opportunities to invest in innovative – and game-changing – companies in the sector. Many of the companies that issue convertible bonds in this space to fuel their growth have not taken on debt other than the convertible bonds issued. From an investor's perspective, a convertible bond represents the ideal way to participate in the progress of these pioneering companies, while limiting downside risk due to the issuers' contractual obligation to preserve capital.

[1]*This paper is part II of a two-part series first published in December 2018. Part I focused on the Technology sector. The paper is available on SSI's website: www.ssi-invest.com*

[2]*Preliminary gross of fee performance as of July 31, 2019. Inception date: 1/1/1983. Net of fee performance: 9.96%. Please see the accompanying disclosure at end of this document for a discussion of performance methodology.*

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SSI performance disclosure continues on next page.

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Definition of the Firm

SSI was established in 1973 and is a Registered Investment Advisor based in Los Angeles, CA. SSI manages assets in domestic and global capital markets. SSI applies quantitative disciplines and fundamental research in its management of alternative and traditional portfolios for institutional and high net-worth investors. SSI manages separate accounts, limited partnerships and acts as sub-advisor to mutual funds. Effective June 1, 2019, Resolute Investment Managers, Inc. will have a majority interest in SSI, however, SSI will continue to operate independently. SSI does not have any subsidiaries. SSI acquired the assets of Froley, Revy Investment Co., Inc. ("Froley, Revy") and its composites as of March 1, 2009.

Policies

SSI's policies for valuing portfolios, calculating performance, and preparing compliant presentations is available upon request.

The Composite & Benchmark

The Convertible Investment Strategy (composite created January 1983) is invested in convertible bonds and convertible preferred stocks, and do not have credit quality restrictions. The Strategy may hold 144A securities. The composite contains fully discretionary accounts including those no longer with the firm. SSI believes a performance comparison versus the ICE BofA Merrill Lynch All Convertibles Index (the "VXA0") is appropriate. The VXA0 measures the return of all U.S. convertibles. SSI does not hold all convertibles in the VXA0 and may also hold convertibles that are not included in the VXA0. The Strategy is less diversified than the VXA0. The volatility of this strategy may be greater than the volatility of the VXA0 as the strategy holds a smaller number of positions than the Index. The return, if any, above the VXA0 is dependent upon SSI's discretionary management. Any other indices shown are not necessarily comparable to SSI's Convertible Investment Strategy. These are widely recognized market indices that are shown for informational purposes only. The composite name was formally known as SSI Outright Discretionary Convertible Strategy from 1/1/1983 – 3/31/2016 and on 4/1/2016 the new composite name became the SSI Convertible Investment Strategy.

Investment Management Fees

Returns are presented gross and net of management fee. Actual results of an individual account may be materially different from the performance shown herein because of differences in inception date, transaction and related costs, restrictions, fees and other factors. All performance is based in U.S. dollars and reflect, on a percentage basis for each of the periods indicated: (a) the net increase (decrease) of all SSI Convertible Investment Strategy portfolios, dollar-weighted, including adjustments for unrealized gains and losses, the reinvestment of dividends and other earnings, the deduction of investment costs except any separate custodial or related fees, time-weighted to adjust for additions and withdrawals, and (b) the net increase (decrease) of the VXA0.

Net performance is reduced by SSI's *actual* investment management fees. Gross performance does not include deduction of SSI's investment management fees.

If performance is gross of management fees, client's actual return will be reduced by the management fees and any other expenses which may be incurred in the management of an investment advisory account. See SSI's Form ADV, Part 2A for a complete description of the investment advisory fees customarily charged by SSI. As an example, an account with an initial $1,000,000 investment on January 1, 2003, earning a recurring 5% semi-annual gross return (10.25% annualized), and paying a .5% semi-annual management fee (1% annual fee) would have grown to $1,340,096 on a gross of fees basis and $1,300,392 on a net of fees basis by December 31, 2005 (3 years).

List of Composites

A list of the Firm's composite descriptions and/or compliant presentations are available upon request. Please contact juliea@ssi-invest.com.

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- When representative portfolio information is shown the representative portfolio is selected by comparing any one (but not limited to) the following criteria: most in line with composite investment objectives /consistency of investment strategy, investment restrictions, fee structure, time frame managed, type of client, size of account.
- Performance prior to January 1, 2000 does not comply with the GIPS standards.
- SSI acquired Froley Revy and its composites as of March 1, 2009. Prior to the acquisition, Froley Revy claimed GIPS compliance for the periods of 1983-2008 and was independently verified by Ashland Partners & Co.

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