



State of Rhode Island
Office of the General Treasurer

Convertible Bond Implementation Staff Recommendation - Advent US Balanced Strategy

April-2022

RECOMMENDATION: Approve a \$100 million allocation to Advent Capital Management Balanced Convertible (US-focused) strategy. The firm is widely considered to be a leading long-only investor in convertible bonds. Advent's Balanced Convertibles strategy is the best fit from Advent's multiple product offerings for ERSRI's investment objectives. The strategy uses a credit-first approach to identify securities with strong bond fundamentals which set a "floor" on convertible bond pricing combined with sufficient upside to maintain a convex return potential (more upside than downside). Advent uses its robust risk monitoring team and tools to manage unwanted exposures and limit drawdown potential.

ASSET CLASS: Liquid Credit (Income Bucket). The target allocation for Liquid Credit is 3%.

PORTFOLIO FIT: The Liquid Credit allocation seeks to invest in below-investment grade liquid corporate debt securities that offer a higher yield than investment grade corporate bonds and may produce return through price appreciation. The recommended allocation to Advent would be complementary to allocation's current high yield bond exposure by adding issuer and sector diversification, providing an attractive convex return profile, reducing the allocation's sensitivity to interest rate risks, and providing additional alpha potential in a less crowded market.

SEARCH PROCESS: Convertible bond investing offers a variety of implementation options across different equity-sensitivity styles, geographic focuses, and portfolio construction approaches. Staff, in conjunction with NEPC, has reviewed several convertible bond strategies. NEPC and Staff aimed to identify an implementation strategy that balances return potential against the risks and costs associated with different strategy features (equity sensitivity, turnover, opportunistic investment approach, risk management approach).

STRATEGY: Advent's US Balanced Convertibles strategy seeks to achieve positive return asymmetry, maximizing equity market upside while limiting downside risk. The strategy achieves this by investing in convertible bonds that exhibit convex return profiles and lie in the "balanced" zone where bonds have a conversion premium of 10-60%, between overly equity-sensitive convertibles with very high deltas (a measure of equity sensitivity) and bond-like convertibles. The strategy is highly diversified with a typical position size of 1-3% (maximum of 5%) and seeks to maintain an adjusted-delta of +/- 0.1 relative to the benchmark (delta of 0.0 means no equity sensitivity and 1.0 matches the underlying stock).

INVESTMENT PROCESS: Advent uses a bottom-up fundamental approach following a preliminary quantitative screen that seeks to identify bonds with attractive risk/return profiles. This screen ensures that bonds under consideration for inclusion in the portfolio exhibit asymmetrical return potential ("balanced deltas), sufficient yield, and attractive bond-only valuations. After filtering to an investible universe, Advent employs a credit first approach to confirm the downside protection offered by the bond portion of the convertible, considering factors such as the issuer's cash flows and interest coverage for the bond. Advent then analyzes the underlying stock and its fundamental drivers for price appreciation to develop a holistic investment thesis.

Analysts are responsible for coming up with investment ideas that are formally reviewed in meetings at least twice weekly. After inclusion in the portfolio, Advent's investment and risk management teams will continue to monitor the position while it maintains its investment potential and desired features (convexity, yield, valuation) and will begin scaling out of the exposure over time as either the investment thesis plays out or the equity prospects deteriorate and the risk/reward dynamics become unfavorable.

MERITS:

- + **DEEP AND FOCUSED EXPERIENCE:** Advent Capital Management was founded in 1995 by Tracy Maitland and currently manages over \$10 billion in long-only convertible bond and hedge fund strategies (the Balanced strategy represents ~\$3B of AUM). The firm's resources are predominately focused on convertible bonds, whereas most other organizations managing converts strategies have limited staff and resources dedicated to managing convertible bond portfolios exclusively. These smaller teams are instead supplemented by broad firm resources such as equity and/or credit research groups who produce analysis from the limited perspective of a stock or bond investor and do not factor in the nuances of convertible bonds and their pricing behavior with the same level of rigor as Advent does. Founder/CIO Tracy Maitland co-manages the Balanced Strategy with Managing Director David Hulme. Together they have almost 60 years of collective experience in the convertible bond segment. They are supported by an investment team of 23, including 8 experienced sector-focused research analysts and a portfolio strategy analyst.
- + **ROBUST RISK MANAGEMENT:** Advent boasts one of the only dedicated convertible bond risk management platforms, which is led by an independent Risk Management Team and Chief Risk Officer. The team creates daily risk reports and consistently tracks portfolio adherence with position limits. On a weekly basis, the team reviews performance attribution with the investment team and performs deeper analysis such as stress tests and multi-factor analysis for scenarios such as five standard deviations movements in equity prices, credit spreads, or equity volatility. The team also uses an eight-factor model to assess liquidity. The Risk Team also reports to the Risk Management Committee of four members including the Chief Risk Officer, the Chief Financial Officer/Chief Administrative Officer, the Chief Operating Officer, and the Director of Research. The Risk Management Committee is responsible for setting internal risk limits by strategy and overseeing risk monitoring policies at the organization.
- + **STRONG PERFORMANCE:** Advent has consistently outperformed its peers (as measured by the eVestment US Convertibles universe) on both an absolute and risk adjusted basis. Advent's US Balanced strategy has repeatedly delivered on its objective to produce positive return asymmetry, achieving a positive upside/downside capture ratio versus US equity markets over the strategy's long-run.

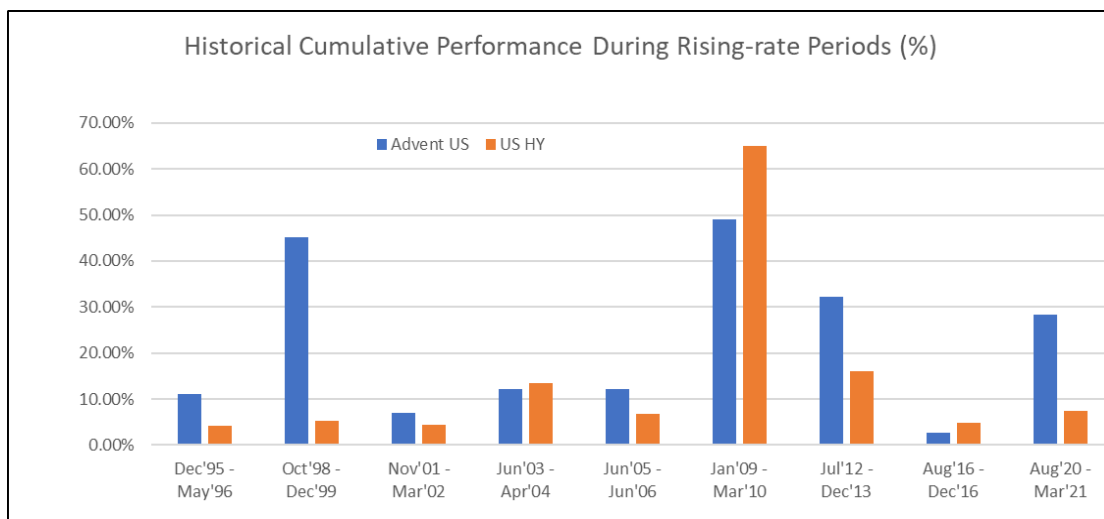
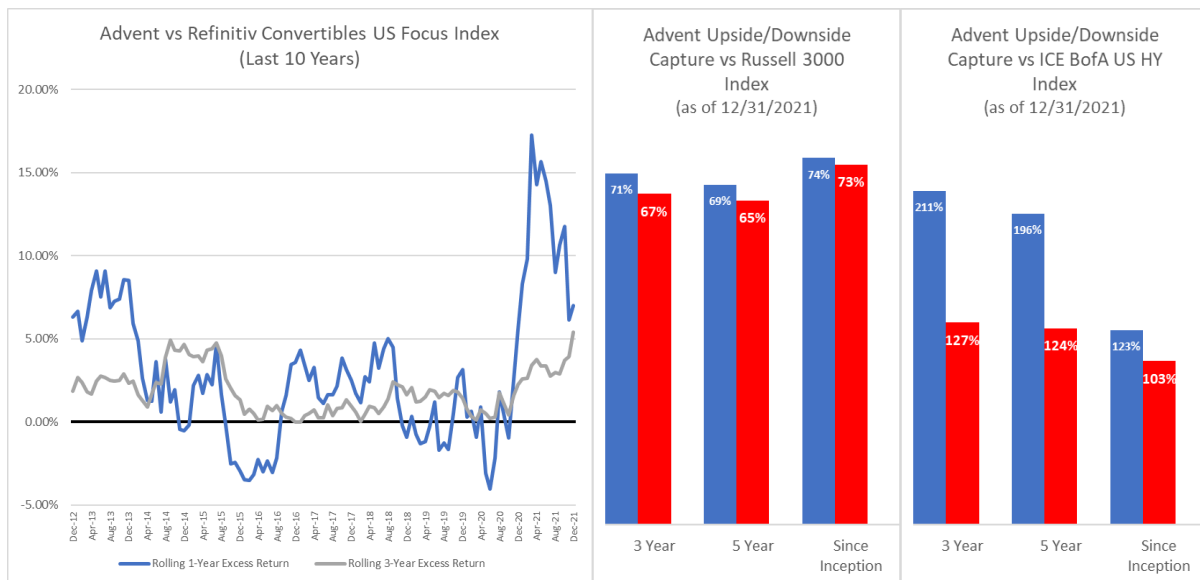
CONCERNS:

- + **KEY PERSON RISK:** Founder and CIO, Tracy Maitland, has nearly 40 years of convertible bond experience and continues to maintain oversight responsibilities for all of the firm's investment activities. Key person risk is mitigated by the fact that Mr. Maitland's Co-Portfolio Manager on the Balanced strategy, David Hulme, possesses nearly 20 years of experience working on the Balanced strategy. Additionally, the Balanced strategy is supported by a deep and experienced group of professionals and resources.
- + **NIMBLENESS:** Advent has much greater AUM in convertible bond-focused strategies than other managers of long-only converts, which may reduce its ability to trade in small bond issues. Additionally, Advent's risk management policies are relatively rigid in compelling it to maintain portfolio characteristics within a target range, particularly with respect to equity sensitivity. This may result in Advent missing out on potential upside equity market capture over the short term in market dislocations or quickly moving rallies. This relatively limited opportunism is counterbalanced by the strong counterparty relationships Advent has developed due to its experience and size, which increase its ability to access new issuance. Additionally, Advent's disciplined risk management practices provide downside protection, contributing to its strong long-term performance relative to peers.

PERFORMANCE:

<i>as of 12/31/2021</i> <i>(returns for periods >1 year are annualized)</i>	1 Year	3 Year	5 Year	7 Year	10 Year	Since Inception (Oct 1995)
Advent US Balanced	4.6%	21.8%	14.9%	11.2%	12.1%	9.7%
Refinitiv Convertibles US Focus Index	-2.4%	16.4%	11.5%	8.7%	9.0%	NA
ICE BofA US Convertible Index	6.3%	24.2%	16.9%	12.9%	13.9%	9.5%
Russell 3000 Index	25.7%	25.8%	18.0%	14.6%	16.3%	10.4%
ICE BofA US High Yield Index	5.4%	8.6%	6.1%	6.0%	6.7%	7.0%

<i>Advent US Balanced vs:</i>	1 Year	3 Year	5 Year	7 Year	10 Year	Since Inception (Oct 1995)
Refinitiv Convertibles US Focus Index	+7.0%	+5.4%	+3.4%	+2.4%	+3.1%	NA
ICE BofA US Convertible Index	-1.8%	-2.4%	-2.0%	-1.7%	-1.8%	+0.2%
Russell 3000 Index	-21.1%	-4.0%	-3.0%	-3.4%	-4.2%	-0.6%
ICE BofA US High Yield Index	-0.8%	+13.2%	+8.8%	+5.1%	+5.4%	+2.7%



10-Yr US Treasury Yield Increase (bps)	+109	+201	+112	+116	+115	+159	+137	+99	+119
--	------	------	------	------	------	------	------	-----	------