Relative Value: A "Diversifier" within an RMS Portfolio

Market Insights from:
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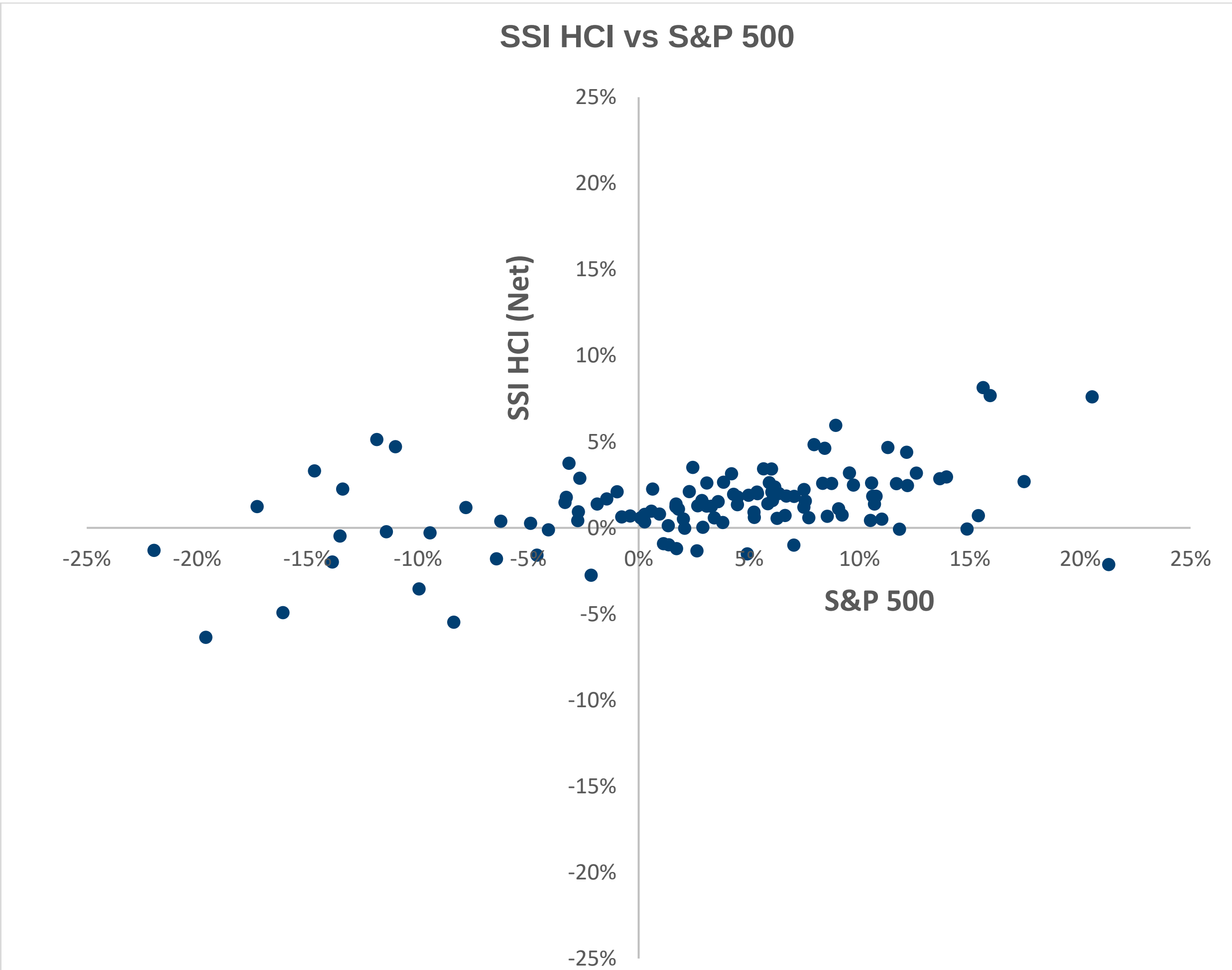
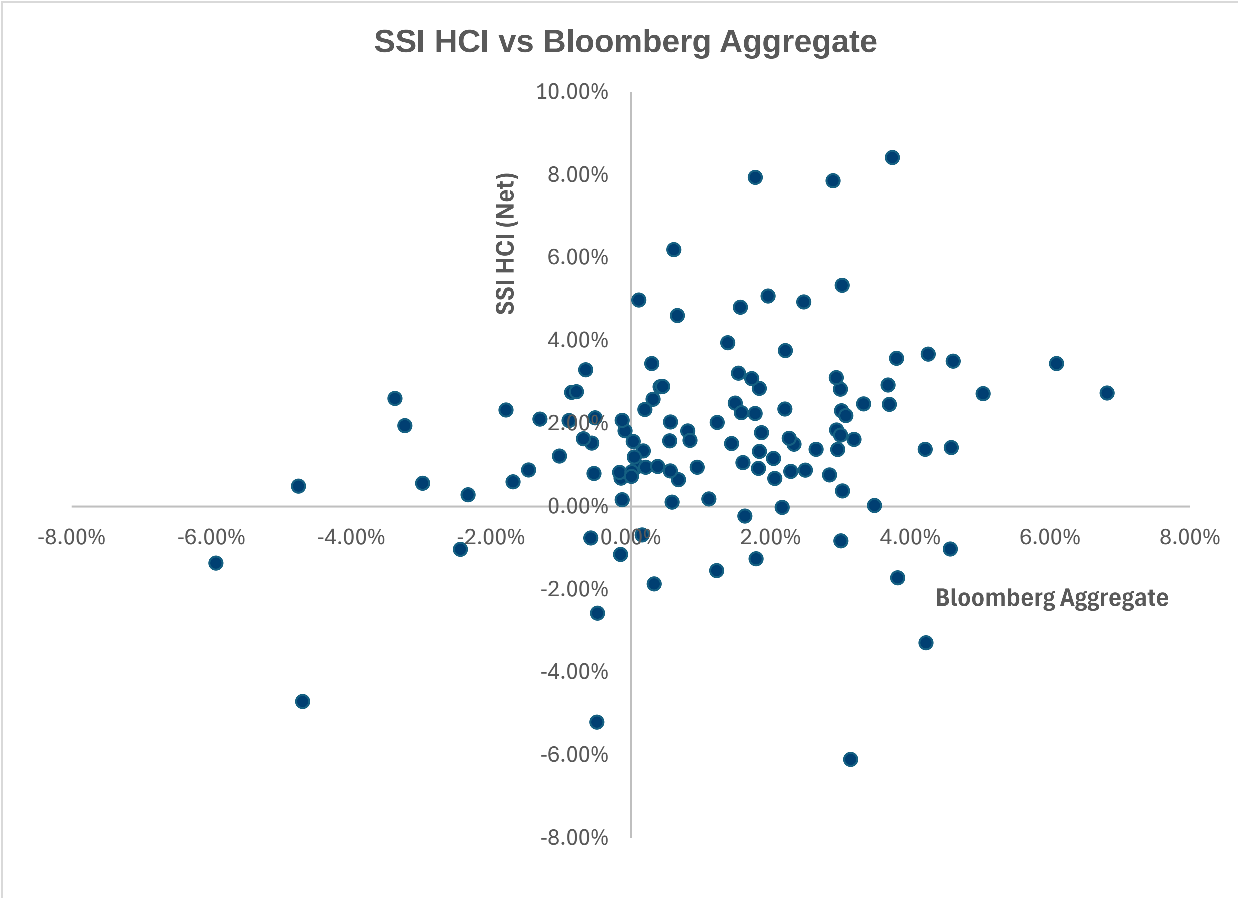
As trends in strategic asset allocation come and go, allocators should not only seek to identify structurally advantaged strategies that offer attractive risk and return characteristics but should also focus on time-tested track records and portfolio managers. The recent increase in interest rates has rightfully drawn the focus back to convertible arbitrage. SSI's Hedged Convertible Income Strategy ("HCI") offers attractive carry, exposure to alternative risk premia and is long equity volatility. It has consistent, measurable risk metrics, low correlation to equities and interest rates and a nearly three-decade track record.

Within the Risk Mitigating Strategy "RMS" framework, Relative Value strategies are "Diversifiers" which provide higher expected returns, but their conditional performance is expected to be lower during a crisis. The scatter plots below illustrate quarterly returns in SSI's HCI Strategy vs the S&P 500 and the Bloomberg Aggregate:

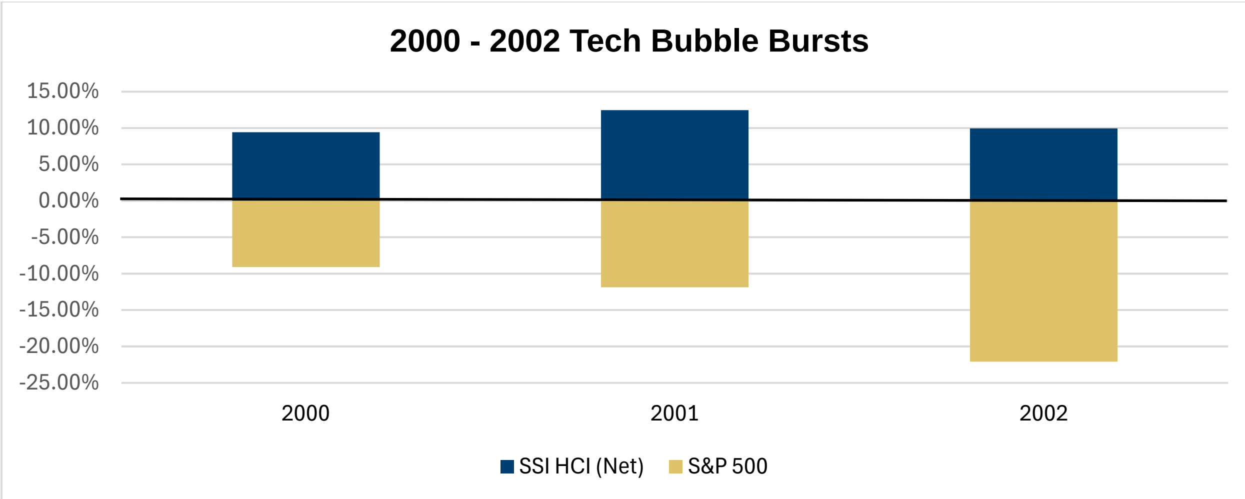


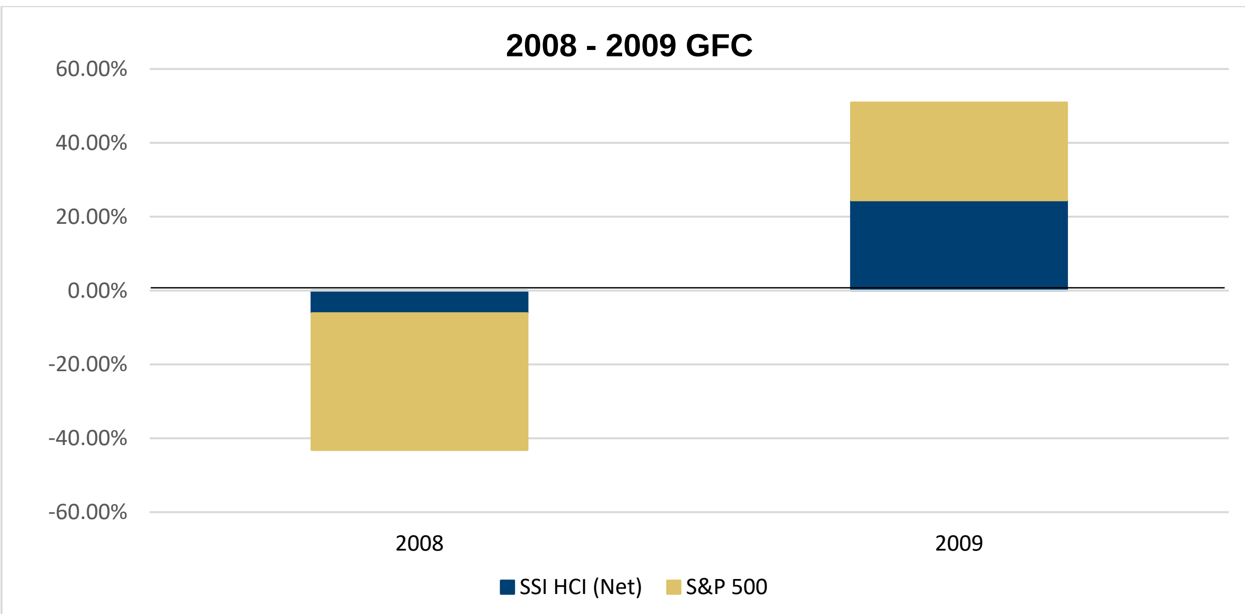


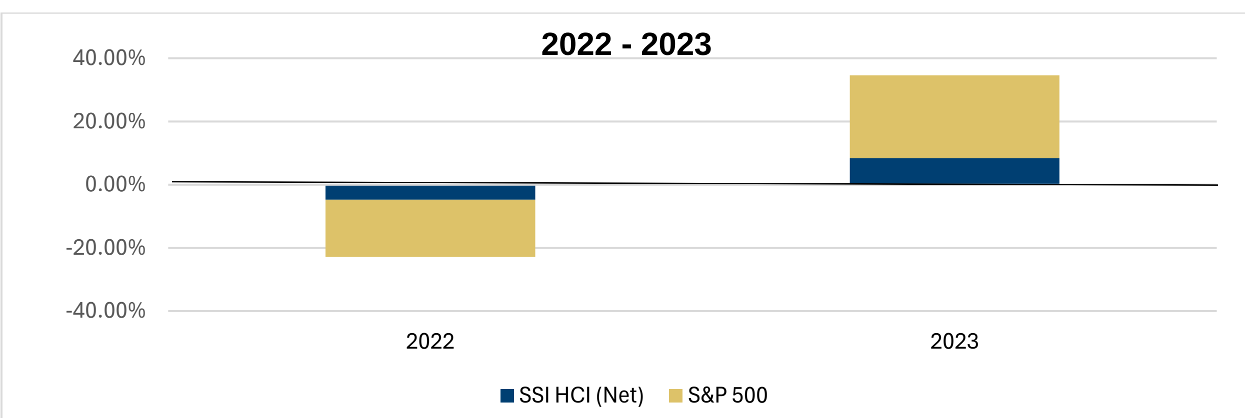
Source for above charts: Bloomberg & SSI internal research. SSI quarterly, net of fee performance as of 3/31/2024. SSI's performance disclosure is located at end of this document.

In comparison to a "First or Second Responder"[1] which offer lower expected returns overall but positive expected returns during drawdowns, SSI's HCI Strategy generally performs well when equities and fixed income are positive and it also provides some protection during drawdowns in both asset classes. Relative Value strategies can be held over the cycle and be expected to be additive to the overall risk and return profile of the portfolio.

The following graphs illustrate SSI's HCI Strategy performance vs the S&P 500 during the largest drawdown periods since we launched the strategy in 1995.





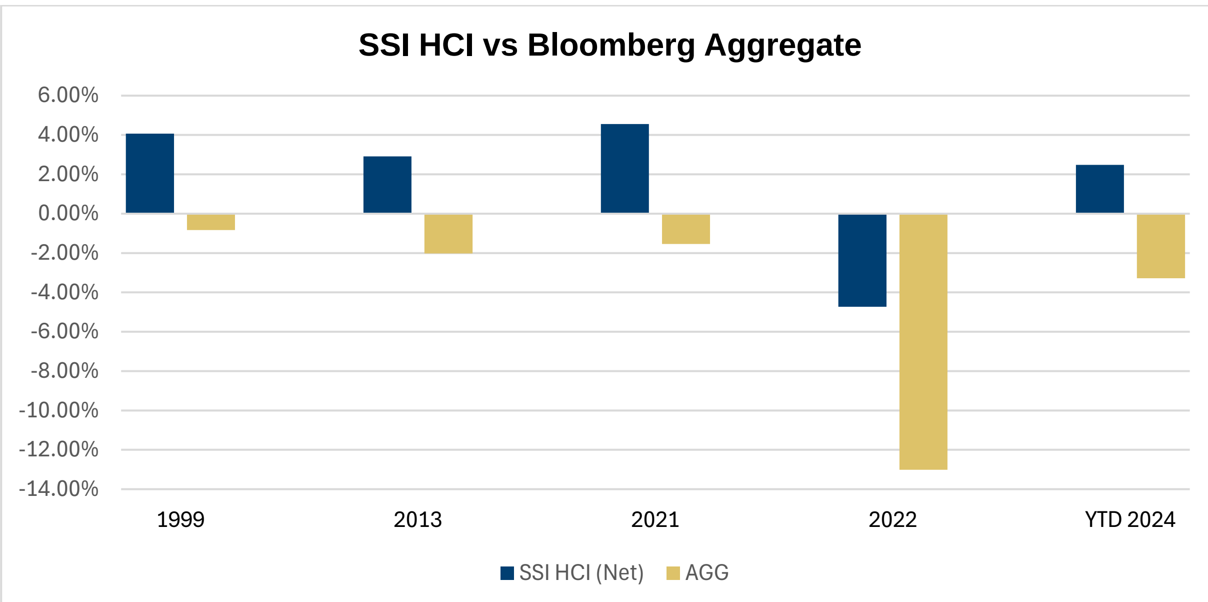


Source for above charts: Bloomberg & SSI internal research. SSI's performance disclosure located at end of this document.

It only took a year for equities to return to breakeven after the 2022 drawdown. However, it took the S&P four years to recover from the 2000 – 2002 drawdown and nine long years to recover from the 2008 sell-off. Assuming a 30% allocation to Intermediate Treasuries, a 5% allocation to SSI HCI and the remaining 65% to equities, the recovery from the 2000 – 2002 drawdown would have taken half the time. That same allocation coming into the 2008 Global Financial Crisis would have recovered by 2009 instead of 2017.

Do you need Relative Value? Couldn't you just use plain vanilla fixed income as your ballast?

Until 2022, drawdowns in the Bloomberg Aggregate had been manageable. As illustrated below, SSI HCI still offered an attractive offset, with positive performance in all the down years for the Bloomberg Aggregate, save for 2022 when our drawdown experience was roughly one-third that of the Bloomberg Aggregate. Relative Value not only improves the Fixed Income return, but it also dampens volatility.



Source: Bloomberg & SSI internal research. YTD performance as of 4/30/2024. SSI's performance disclosure located at end of this document.

Staying on the topic of interest rates, let's consider how the recent "higher for longer" environment has been beneficial. 3-Month T-bill rates were at similar levels to today for the first six years of the Strategy:

Year	SSI HCI Net	FTSE 3 Month T-Bill
1995	14.64%	5.75%
1996	9.35%	5.25%
1997	8.00%	5.25%
1998	-1.59%	5.06%
1999	4.07%	4.74%
2000	8.50%	5.96%

Source: Bloomberg & SSI internal research. SSI's performance disclosure located at end of this document.

Why does the strategy do well when short rates are higher and where does the product fit in the RMS framework?

The strategy utilizes an unlevered convertible arbitrage framework which has an "Explicit Hedge" via an embedded long call option and has done well in periods of "Event Duration", such as the Tech Bubble and the GFC. Diving into further detail, the strategy has three sources of return:

- **Income** – when interest rates are higher, coupons increase. Also, since the strategy involves purchasing a convertible bond and selling short the underlying stock, the strategy benefits from higher short rates. It earns slightly less than the Fed Funds Rate on the cash generated by shorting stock.
- **Gamma Trading** – this is the "Explicit Hedge". The convertible bond has an embedded call option and thus you are long equity volatility (gamma). This acts as a ballast in equity drawdowns.
- **Mispricing** – this can vary greatly. When markets become dislocated, convertible securities can offer outsized returns, as 2009 illustrates. The Non-Investment Grade portion of the convertible bond market, where the SSI HCI Strategy focuses, currently trades roughly 300 basis points wider than the High Yield BB option adjusted spread. **These are the widest levels we have seen in over a decade.**

The first two elements of return – income and gamma - also allow for a "baseline" return or carry, unlike other Relative Value strategies. The yield on the portfolio and gamma are observable and the options market provides a measure of expected equity volatility. Rho, or effective duration, is the best measure of how the portfolio can be expected to perform during periods of widening credit spreads. The effective duration of the strategy has ranged between 1.5 – 2.5. The long-term correlation to interest rates is zero and equity beta has been under 0.2.

At present, the portfolio offers the following characteristics[2]:

Return Source	**HCI (unlevered)**
Income	4 – 8%
Gamma Trading	2 – 3%
Mispricing	1 – 2%
Total Return Objective	**7 – 13%**

Reasons to Expect Growth in the Convertible Market

SSI, along with other industry experts, feels that the market could grow meaningfully over the next several years given the coupon advantage offered by a convertible bond, the higher absolute level of interest rates, and pending maturing walls in High Yield and Investment Grade. Presently, a company can issue a convertible bond at a rate substantially lower than it earns on cash, invest the money and earn the spread. With short rates being higher, the convertible arbitrage manager increases the yield on the position by earning a rebate based on the Fed Funds Rate on the short cash, as detailed above. As also noted above, gamma trading can also be expected to contribute 2 – 3% annually on an unlevered basis.

In conclusion, it behooves investors to consider SSI's HCI Strategy for inclusion in their RMS portfolio. The Strategy has proven itself through multiple market cycles over the last thirty years. It benefits in the current environment of higher interest rates, is long equity volatility and has a short duration, all features which allow the strategy to provide an attractive offset to drawdowns in both equities and traditional fixed income. It also generates attractive risk-adjusted returns over time.

[1]*Meketa White Paper: Risk Mitigating Strategies (RMS) Framework (March 2023); Strategies utilized as first responders are expected to be the first line of defense and produce meaningful gains in the initial stages of an equity drawdown or market shock, while second responders aim to provide a second line of protection in an equity drawdown*

[2]*SSI Return Source Characteristics are based on gross of fee performance returns*

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SSI's performance disclosure continues on next page.

Performance Disclosure

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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, a limited partnership, and acts as sub-advisor to mutual funds and an ETF. Effective June 1, 2019, Resolute Investment Managers, Inc. ("Affiliated Advisor") has 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 investments, calculating performance, and preparing GIPS reports are available upon request.

The Composite & Benchmark (Description & Material Risks)

The SSI Hedged Convertible Income Strategy (composite inception date January 1, 1995; composite created January 1, 1995) invests long in a diversified portfolio of convertible bonds/preferreds and short the underlying common stocks or call options to attempt to achieve an absolute return. The composite contains fully discretionary accounts including those no longer with the firm. With interest rebates on short sales and coupon interest on convertible bonds comprising a consistent and important component of the return of the SSI Hedged Convertible Income Strategy, SSI believes a performance comparison versus the FTSE 3 Month Treasury Bill ("3 Month T-Bill") is appropriate. The volatility of this strategy is expected to be greater than the volatility of the 3 Month Treasury Bill due to the inclusion of convertible and equity positions. The return, if any, above the 3 Month T-Bill is dependent upon higher interest income available in the convertible market and SSI's discretionary management. Any other indices shown are not necessarily comparable to SSI's Hedged Convertible Income Strategy. These are widely recognized market indices that are shown for informational purposes only and are supplemental to SSI's GIPS reports. The composite name was formally known as SSI Hedged Convertible Income Strategy from 1/1/1995 – 6/30/2008, SSI Convertible Income Strategy 7/1/2008-4/30/2024 and on 5/1/2024 the composite name became the SSI Hedged Convertible Income Strategy. Citigroup's 90 Day T-Bill was acquired by London Stock Exchange Group (LSEG) and beginning 8/1/2018 the new name is FTSE 3 Month Treasury Bill ("3 Month T-Bill").

Use of Leverage, Derivatives, and Shorts

Leverage is not used in SSI's Hedged Convertible Income Strategy and the use of derivatives is not material. The Strategy is generally fully hedged and involves buying a convertible bond/preferred and shorting the underlying common stock or call option in order to reduce the equity exposure.

Investment Management Fees

Returns are presented gross and/or 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, investment guideline 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 Hedged Convertible Income Strategy portfolios, asset-weighted, including adjustments for unrealized gains and losses, the reinvestment of dividends and other earnings, the deduction of investment costs, the deduction of limited partnership and/or mutual fund costs (if any), time-weighted to adjust for additions and withdrawals, and (b) the net increase (decrease) of the 3 Month T-Bill.

Net performance for fee paying portfolios is reduced by SSI's actual investment management fees and non-fee paying portfolios are reduced by a 1% annual model fee (1/1/1995-10/31/2023) and by a 0.85% annual model fee (11/1/2023-present). Model fees are deducted on a monthly basis. 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, 2022, 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, 2024 (3 years).

List of Composites

A list of the Firm's composite descriptions, limited distribution pooled funds (LDPFs) and/or GIPS reports are available upon request. Please contact helenm@ssi-invest.com.

Additional Disclosure

● SSI operated under the name of SSI Investment Management, Inc. (1/1/1973-4/30/2019) and as of 5/1/2019 operates as SSI Investment Management LLC.

● 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.

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