Convertible Arbitrage

NICHOLAS INVESTMENT PARTNERS

Key Takeaways

- Nicholas Partners Convertible Arbitrage delivered positive returns amid a period of rising interest rates, higher volatility and mixed returns for hedge funds.
- Security selection was the key driver of absolute performance, as strong company fundamentals were rewarded.
- Innovation-driven companies in healthcare and technology were particularly strong performers.

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Composite Performance (Unlevered) as of September 30, 2018

RETURNS (%)	CONVERT ARB (GROSS)	CONVERT ARB (NET)	3-MONTH T-BILL[1]
MTD	0.14%	0.06%	0.15%
QTD	1.34%	1.08%	0.49%
YTD	3.22%	2.45%	1.30%
1 YEAR	3.84%	2.81%	1.59%
3 YEAR	4.02%	2.99%	0.84%
5 YEAR	2.46%	1.44%	0.52%
7 YEAR	3.87%	2.83%	0.39%
10 YEAR	6.00%	4.94%	0.34%
ITD*	5.16%	4.12%	1.30%

**Composite inception date: 11/1/2002. Returns over one year are annualized. See performance disclosure for additional information. Past performance is no guarantee of future results. [1]ICE Bank of America/Merrill Lynch 3-month T-bill.*

MARKETS DYNAMICS

It was a strong quarter for equities. Stocks scaled a wall of worry in Q3, driven by a mix of renewed synchronized global economic growth, robust Q2 earnings growth and strong Q3 forecasts. Companies found innovative ways to compete and excel.

- The S&P 500 Total Return Index rose 7.7%—its best quarterly performance since Q4 2013.
- All US cap sizes posted gains and large caps outpaced mid and small caps.
- Growth significantly outperformed value in all cap sizes.

Credit markets faced challenges. US Treasury yields rose across the curve, reflecting increases in potential growth and additional rate hikes based on the Fed's telegraphed intention to maintain its interest-rate and balance-sheet normalization process. US corporate bond performance was mixed as the yield curve flattened.

- The 10-year Treasury yield closed at 3.05%, up 20 basis points, and continued to breach its five-year high heading into October.
- The Bloomberg Barclays US Agg Bond Index fell 0.16%, vs. a 1.03% gain for the Bloomberg Barclays US Corporate High-Yield Bond Index.

Convertibles continued to rally. Strength in their underlying equities and tight corporate credit spreads helped convertibles deliver modest gains, led by healthcare and tech issues. The primary convertible market remained strong.

- The Thomson Reuters All Cap Focus Convertible Index locked in a 2.01% return.
- New convertible issuance maintained a healthy pace, with 27 issues raising $11.6 billion—enough to push YTD totals above the full-year levels for 2017 (i.e., 122 issues and $46.3 billion).

LOOKING AHEAD

Equities are attractive—but not without risk. While we see further upside driven by company fundamentals, the US economic expansion and upward revisions of earnings and revenue estimates, we're also aware that the expansion cycle is in its later stages—meaning that growth and valuations are more vulnerable to changing investor sentiment or potential external shocks.

As we write in October, stocks have already taken a hit from jitters about rising yields across the curve, China and the potential for a US-China trade war to hamper US earnings growth. We wouldn't be surprised by additional choppiness in Q4 (particularly in the runup to and aftermath of the November US midterm elections), but expect markets to weather the storm and enter 2019 with fundamentals in good shape given the ongoing strength in secular growth.

WHERE WE STAND NOW

Emphasis on innovation. With rising volatility putting a premium on effective stock selection, we continue to focus on innovation-driven companies.

Growth style to remain strong. The factors we've cited—innovation, the supportive economic environment, positive earnings and revenue estimates, particularly in small cap—should keep growth stocks strong heading into 2019. If growth slows due to an external shock, investors would likely prize growing companies with high earnings transparency.

More upside for convertibles. We remain optimistic about convertibles, which benefit from strength in underlying stocks, healthy new issuance and relatively favorable monetary conditions. The asset class continues to offer attractive risk-controlled equity exposure, income and a lower duration than bonds at a time when equity valuations are at the higher end of their range and rates are rising.

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PERFORMANCE ATTRIBUTION

Nicholas Partners Convertible Arbitrage closed Q3 in positive territory with a return of 1.34% (before fees). In comparison, the DJCS Convertible Arbitrage Index (leveraged) dipped -0.92% during the quarter while the ICE BofA/Merrill Lynch Convertible Hedge Index (leveraged) subtracted -3.52%.

Security selection was the key driver of performance and the distribution of contribution to portfolio returns was positively skewed, driven by strong company fundamentals. The split between long/short performance attribution was 4.89% vs. -3.64% in Q3.

Healthcare and technology net sector exposures were the most additive to Q3 absolute returns (+133 bps). Exposures to biotech and healthcare technology also performed well. Energy and industrials positions modestly diluted absolute returns, subtracting -21 bps for the period.

On a net basis, the portfolio's top five contributors to Q3 performance included Teladoc (tele-healthcare services), Exact Sciences (colorectal cancer diagnostics), Square Inc (mobile payment processing), Atlassian Corp (enterprise collaboration software) and Integrated Devices Technology (semiconductors). Teladoc, specifically, continued to benefit from strong revenue growth supported by higher membership and utilization trends, and reported better-than-expected revenue growth in Q2. With respect to Integrated Devices, its share price benefited from news that the company will be acquired by Renesas, a Japanese semiconductor supplier, at a premium for ~$6.7 billion.

The five largest detractors included NXP Semiconductors (semiconductors), PDC Energy (oil and gas production), Greenbrier Companies (rail transportation), Golar LNG (liquid natural gas storage and transport services) and ctrip.com (mobile and online travel services). The small magnitude of negative contributors in Q3 is noteworthy. Based on due diligence reviews of PDC Energy, Greenbrier, Golar LNG and ctrip.com there were no company specific events. We continue to hold these positions as we confirmed that the growth catalysts and fundamental strength of these companies remain intact. With respect to NXP, we sold the position as Qualcomm ends deal to acquire NXP.

Contribution to Portfolio Absolute Return 3Q 2018

NET SECTOR	CONTRIB
Consumer Discretionary	0.02%
Consumer Staples	0.00%
Energy	-0.11%
Financials	0.07%
Health Care	0.63%
Industrials	-0.10%
Information Technology	0.71%
Materials	0.01%
Real Estate	0.00%
Telecommunication Services	0.00%
Utilities	0.00%

TOP 5 CONTRIBUTORS	SECTOR	CONTRIB
Teladoc Inc	Health Care	0.21%
Exact Sciences Corporation	Health Care	0.15%
Square Inc	Technology	0.14%
Atlassian Corporation	Technology	0.14%
Integrated Device Technology	Technology	0.13%

BOTTOM 5 DETRACTORS	SECTOR	CONTRIB
NXP Semiconductors	Technology	-0.07%
PDC Energy Inc	Energy	-0.06%
Greenbrier Companies Inc	Industrials	-0.06%
Golar LNG Ltd	Energy	-0.06%
ctrip.com International	Consumer Discretionary	-0.05%

Source: Monis, Nicholas Investment Partners. Attribution is based on a representative portfolio. Specific securities identified do not represent all securities purchased, sold or recommended to advisory clients. It should not be assumed investments in these securities were or will be profitable. Past performance is no guarantee of future results.

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POSITIONING

The Nicholas Partners Convertible Arbitrage structure did not change significantly from the prior quarter. As of September 30, 2018, the portfolio remained fully invested with a net cash position of 3.9%. The portfolio's current yield is 1.67% with a weighted average bond duration of 4.65 years. We continue to actively manage the portfolio's hedges as stock prices move and as we discern changes in near-term fundamentals.

At quarter end, the portfolio was positioned with a delta-adjusted net exposure of 10.6%, lower than 11.6% the prior quarter and reflective of our focus on securities with a more asymmetrical risk/reward profile. Net exposure to consumer discretionary and financials incrementally increased over the quarter as we added to existing positions. The Fund's net exposure to healthcare decreased as we exited positions, such as Teladoc, BioMarin Pharmaceuticals among others, to realize profits and/or reduce security-specific risk.

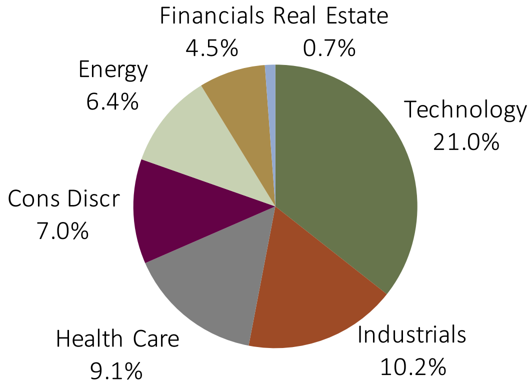
We continue to favor innovation-driven companies with differentiated secular growth themes, more domestically-oriented revenue exposure, and those with strong financials and the ability to finance growth internally. As of September 30, 2018, the Fund's largest net exposures were in technology, industrials and healthcare. Within technology specifically, the portfolio's exposure is predominately expressed in cloud computing, software-as-a-service (SaaS) and internet services holdings. We believe high-tech capex spending is gaining momentum, providing a sustainable growth catalyst that may help drive earnings and/or revenue growth acceleration for these companies. We also believe these companies may be more isolated from global trade wars.

FIXED INCOME CHARACTERISTICS	CONVERTIBLE ARBITRAGE	TR US ALL CAP FOCUS (CVTS)
Coupon (%)	1.88	1.53
Current Yield (%)	1.67	1.46
Yield to Worst (%)	-1.34	-1.03
Bond Duration	4.65	4.80
Years to Maturity/Put	5.45	4.44
Delta (%)	66	60
Gamma (%)	0.48	0.63
Points to Bond Floor	32.17	24.43

PORTFOLIO EXPOSURE (%)	
Long Exposure	101.0
Short Exposure	43.3
Net Exposure	57.7
Theo. Delta Adjusted Net Long	10.6

TOP 5 LONG POSITIONS (%)	
Atlassian 0.625% @ 01-May-2023	3.2
Golar Lng 2.75% @ 15-Feb-2022	3.2
Exact Sciences 1.0% @ 15-Jan-2025	3.0
Ligand Pharma 0.75% @ 15-May-2023	2.9
Pure Storage 0.125% @ 15-Apr-2023	2.8

NET SECTOR EXPOSURE (%)



Source: Monis, FactSet, Nicholas Investment Partners. Attribution is based on a representative portfolio. Specific securities identified do not represent all securities purchased, sold or recommended to advisory clients. It should not be assumed investments in these securities were or will be profitable. Past performance is no guarantee of future results.

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Performance contribution/attribution, characteristics and portfolio risk statistics information is from a representative account for the strategy composite. The representative account was chosen based on non-performance criteria such as account size, cash flows and the level of account restrictions. While Nicholas believes the information is representative of other accounts in the strategy, specific information for other accounts may differ from the representative account. Nicholas used third-party information in the preparation of the characteristics and/or market environment charts. While Nicholas believes the third-party information was obtained from reliable sources, we cannot guarantee the accuracy, adequacy or completeness of the information obtained from these sources.

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Gross and net returns, presented within were calculated in U.S. dollars on a time-weighted, total return basis, including reinvestment of all dividends, interest and income, realized and unrealized gains or losses and are net of brokerage commissions, execution costs, and any applicable foreign taxes. Accrual accounting was used for dividend income recognition. Securities transactions are accounted for on trade date. Cash and cash equivalents are included in the performance returns. The gross returns do not give effect to investment advisory fees which would reduce gross returns. The deduction of investment advisory fees will reduce gross returns and are subject to compounding. The composite results include all actual, fee paying fully discretionary accounts under management by Nicholas after one full calendar month that have substantially the same investment objectives, policies and restrictions. Unless otherwise noted the returns reflect the performance of the product composite. Performance and incentive based fees will have similar, yet often larger, impacts to performance and account values than standard management fees. Please see Nicholas' ADV Part 2A for a complete description of investment advisory fees.

Net returns reflect the deduction of the highest investment management fee for the product, which is 1.00%. Actual fees charged may vary by portfolio due to various conditions such as account size, client relationship, complexity, etc. Client's accounts may also be subject to additional fees unrelated to Nicholas such as custodial and administration fees, among others.

The performance of the Convertible Arbitrage Composite noted above includes an account managed by the portfolio manager while employed at his previous firm, CapitalWorks Investment Partners, LLC which became a client of Nicholas Investment Partners on December 1, 2007. The portfolio manager was the primary portfolio manager responsible for the trading activity of this strategy. Performance data from November 1, 2002 (inception) through November 30, 2007 reflects performance at the previous investment adviser. Performance data from December 1, 2007 forward is reflective of performance of the strategy managed by the portfolio manager as an employee of Nicholas Investment Partners.

Disclosure *(continued):* The Convertible Arbitrage strategy objective is to achieve a positive rate of return. Due to the lack of a specific market index that is directly comparable to the Convertible Arbitrage strategy based on asset class, risk profile and the absolute return objective of the strategy, we include the return and risk information for the Bank of America/Merrill Lynch US 3 Month T-Bill Index ("3 Month T-Bill Index") as the primary index comparison for informational purposes. The risk profile and return pattern of the Convertible Arbitrage strategy is significantly different from the risk profile and return pattern of the 3 Month T-Bill Index, which is generally considered a low risk investment represented by short-term government securities. The Convertible Arbitrage strategy invests in convertible bonds, convertible stock and common stock which are subject to various risks such as market, liquidity, credit, interest rate and conversion risk, among others. All investments are subject to some degree of market and investment specific risk, among others, and may limit the level of downside protection realized by the strategy.

Convertible Arbitrage strategies generally involve long convertible bond positions with the short sale of the underlying (or similar) equities as a hedge. A short sale is a transaction in which an account sells a security it does not own in anticipation that the market price of that security may decline. Selling securities short involves unlimited risk as the security's price can theoretically continue to appreciate indefinitely which may result in unlimited losses. In addition, short positions typically involve increased liquidity risk, transaction costs, and the risk that the third party to the short sale may fail to honor its contract terms. The account may have to pay a fee to borrow securities and is often obligated to pay over any accrued interest and dividends on such borrowed securities to the buyer. Any gain will be decreased, and any loss increased, by the transaction costs described above. The successful use of short selling may be adversely affected by imperfect correlation between movements in the price of the security sold short and the securities being hedged.

Convertible Arbitrage strategies generally involve long convertible bond positions with the short sale of the underlying (or similar) equities as a hedge. A short sale is a transaction in which an account sells a security it does not own in anticipation that the market price of that security may decline. Selling securities short involves unlimited risk as the security's price can theoretically continue to appreciate indefinitely which may result in unlimited losses. In addition, short positions typically involve increased liquidity risk, transaction costs, and the risk that the third party to the short sale may fail to honor its contract terms. The account may have to pay a fee to borrow securities and is often obligated to pay over any accrued interest and dividends on such borrowed securities to the buyer. Any gain will be decreased, and any loss increased, by the transaction costs described above. The successful use of short selling may be adversely affected by imperfect correlation between movements in the price of the security sold short and the securities being hedged.

From inception through December 31, 2017, the index presented for characteristics comparisons was the Bank of America Merrill Lynch All Qualities All Convertibles Index (BAML Convertible Index). Beginning on January 1, 2018 the primary characteristics index changed to the Thomson Reuters US All Cap Focus Convertible Index (TR All Cap Focus Convertible). The change was made due to the introduction of the newly created TR All Cap Focus Convertible index in late 2017 which is constructed in manner that better reflects our investment strategy and universe. The index was retroactively calculated from January 1994 to 2017 using existing index data from a broader level convertible index maintained through time. For more information on the index construction methodology and historical data please contact Nicholas at info@nicpartners.com.

The Thomson Reuters US All Cap Focus Convertible Index is a market capitalization weighted, total return index designed to provide a broad measure of the performance of the active, balanced US convertible bond market. Qualifying fixed income securities may be rated investment grade or non-investment grade or unrated, may be issued with fixed or floating rates and must meet minimum size and liquidity requirements. Mandatory and perpetual issues are excluded. Balanced issues are selected using price and premium thresholds. The index is reviewed monthly to ensure the constituents' continued compliance with the Index rules, issues may be added only at the monthly review though bonds may be removed from the Index at any time as a result of corporate or market events. Individual issuers are capped at 3% of the Index at each monthly review.

The ICE Bank of America/Merrill Lynch All Quality Convertibles Index (VXA0) is comprised of US denominated convertible securities of all qualities not currently in bankruptcy spanning all corporate sectors and having a par amount outstanding of $50 million. Maturities must be at least one year.

Nicholas Investment Partners, L.P. is an independent, employee-owned and majority women-owned investment boutique focused on investing in dynamic, less efficient markets such as US small- and mid-cap equities and convertible bonds. We believe that change creates opportunity. We invest in dynamic companies with accelerating revenue and/or earnings growth in which our research confirms the company's growth is sustainable and the company's stock is a timely investment. Our edge comes from combining fundamental equity and credit research with the objectivity and efficiency of quantitative analytics. We have a results-driven and client-centric culture centered on building lasting and value-added relationships with a select group of institutional and private wealth clients and consultants.

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