Strategy Update | 3Q 2018

Convertibles

NICHOLAS INVESTMENT PARTNERS

Key Takeaways

- Nicholas Partners Convertible portfolio delivered positive returns amid a period of rising interest rates, higher volatility.
- 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 as of September 30, 2018

RETURNS (%)	CONVERTS (GROSS)	CONVERTS (NET)	TR US ALL CAP FOCUS[1]	ML AQ CONVERTS[2]
MTD	-0.53%	-0.59%	-0.81%	-0.25%
QTD	3.64%	3.45%	2.01%	3.93%
YTD	9.65%	9.04%	8.04%	10.43%
1 YEAR	9.74%	8.92%	9.75%	12.16%
3 YEAR	7.80%	6.99%	8.22%	11.83%
5 YEAR	5.67%	4.88%	6.36%	9.31%
7 YEAR	9.31%	8.49%	8.35%	11.96%
ITD*	12.25%	11.42%	9.44%	13.67%

**Composite inception date: 1/1/2009. Returns over one year are annualized. See performance disclosure for additional information. Past performance is no guarantee of future results. [1]Thompson Reuters US All Cap Focus (convertibles) index. [2]BofA/Merrill Lynch All Quality Convertibles index.*

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 strategy closed Q3 in positive territory to lock in a 3.64% (before fees) absolute return. In comparison, the Thomson Reuters All Cap Focus Convertible Index, a more balanced convertible index, gained 2.01% for the quarter while the ICE BofA/Merrill Lynch AQ Convertible Index added 3.93%.

Security selection was the key driver of performance, driven by strong company fundamentals. Technology and healthcare sector exposures were the most additive to Q3 absolute returns (~+455 bps). Software services and biotech holdings were particularly strong performers. Consumer discretionary and energy positions modestly diluted absolute returns, subtracting approximately -66 bps for the period. The portfolio's hotel exposures pulled back. Caesars Entertainment, notably, had tough Q3 due to softer-than-expected bookings. We continue to hold the position as our research indicates bookings are expected to be back on track next quarter.

The portfolio's top five contributors to Q3 performance included Teladoc (tele-healthcare services), Square Inc (mobile payment processing), Integrated Devices Technology (semiconductors), Atlassian Corp (enterprise collaboration software) and IAC/InterActive Corp (media internet services). 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 Twitter, Inc. (social media), Microchip Technology (semiconductors), Supernus Pharmaceutical (treatments for central nervous system disorders), Nutanix, Inc. (cloud virtualization and storage solutions) and Tesla (electric car manufacturer). In the case of Supernus, the stock traded off after reporting Q2 in line with expectations but did not beat. Subsequently a short story circulated suggesting competitive pressures from a new class of migraine drugs may dampen further upside to the stock. Twitter disappointed during the quarter. In terms of the other detractors, we continue to hold these positions as we confirmed that the long-term growth catalysts and fundamental strength of these companies remain intact.

Contribution to Portfolio Absolute Return 3Q 2018

SECTOR	CONTRIB
Consumer Discretionary	-0.40%
Consumer Staples	0.00%
Energy	-0.26%
Financials	0.06%
Health Care	2.09%
Industrials	-0.19%
Information Technology	2.46%
Materials	0.00%
Real Estate	0.03%
Telecommunication Services	0.00%
Utilities	0.00%

TOP 5 CONTRIBUTORS	SECTOR	CONTRIB
Teladoc Inc	Health Care	0.60%
Square Inc	Technology	0.51%
Integrated Device Technology	Technology	0.51%
Atlassian Corporation	Technology	0.46%
IAC/InterActiveCorp	Technology	0.41%

BOTTOM 5 DETRACTORS	SECTOR	CONTRIB
Twitter Inc	Technology	-0.26%
Microchip Technology	Technology	-0.23%
Supernus Pharmaceuticals	Health Care	-0.19%
Nutanix Inc	Technology	-0.16%
Tesla Inc	Consumer Discretionary	-0.16%

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

Near-term we expect increased volatility ahead of upcoming key economic data and a choppier trading environment as investors may be quick to take profits amid broader macro concerns (i.e. rising rates, bifurcation of global growth, global trade wars). As the focus shifts back to earnings, we believe the fundamental backdrop for innovation-driven subsectors remains positive with expectations of continued sales growth strength longer term.

The Convertibles portfolio structure is reflective of our focus on securities with an asymmetrical risk/reward profile. We opportunistically realized profits in some issues, such as Integrated Devices. The assets were reinvested into securities where the underlying company meets our dynamic growth criteria and exhibit a balanced profile.

As of September 30, 2018, the portfolio remained fully invested with a cash position of 1.7%. The representative portfolio has a current yield of 1.67% and a weighted average bond duration of 4.77 years. Underlying equity characteristics reflect our focus on investing in dynamic growth companies with 19.6% EPS Growth (FY1/FY2 median) and traded at a P/E (FY2 median) of 16.8x.

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. Portfolio exposure to consumer discretionary and healthcare holdings incrementally increased over the quarter as we added new positions. At quarter end, the portfolio's largest sector exposures were in technology (39.4%) and healthcare (16.6%). Innovation and strong secular growth trends in software-as-a-service, oncology and gene therapy remain strong and the portfolio reflects a particular focus to those markets. Relative to the Thomason Reuters benchmark, the portfolio was overweight industrials (+9.5%) and financials (+2.3%) stocks and underweight in consumer discretionary (-4.1%) and technology (-4.1%).

We remain vigilant in selecting companies whose convertible security that have secular growth drivers and high-quality management teams able to execute through a changing business climate, and where we have high visibility and confidence in future growth.

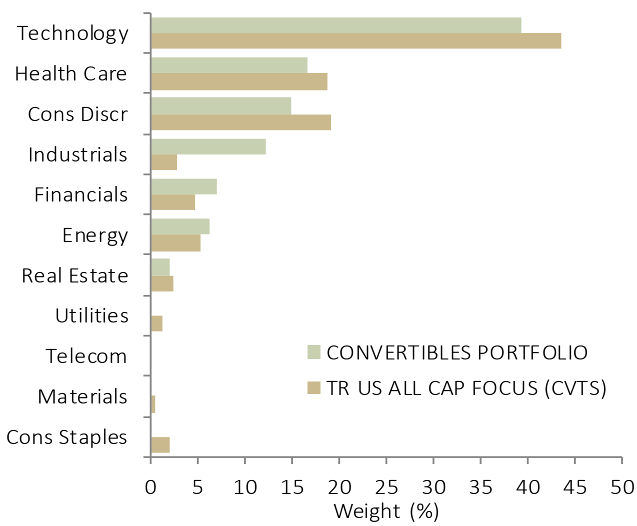
FIXED INCOME CHARACTERISTICS	CONVERTIBLES	TR US ALL CAP FOCUS (CVTS)
Coupon (%)	1.90	1.53
Current Yield (%)	1.67	1.46
Yield to Worst (%)	-1.38	-1.03
Bond Duration	4.77	4.80
Years to Maturity/Put	5.59	4.44
Delta (%)	66	60
Gamma (%)	0.49	0.63
Points to Bond Floor	32.97	24.43

EQUITY CHARACTERISTICS	CONVERTIBLES	RUSSELL 3000
Number of Securities	62	3,024
Market Cap*	$7.1 B	$1.9 B
P/E* (FY2)	16.8 x	15.7 x
P/B*	3.6 x	2.3 x
EPS Growth (FY1/FY2)*	19.6%	12.0%

**Median*

TOP 10 POSITIONS (% weight)	CONVERTIBLES
Palo Alto Networks 0.75% @ 01-Jul-2023	3.0
Microchip Technology 1.625% @ 15-Feb-2027	2.5
Exact Sciences 1.0% @ 15-Jan-2025	2.5
GCI Liberty 1.75% @ 30-Sep-2046	2.5
Golar Lng 2.75% @ 15-Feb-2022	2.4
Jazz Investments 1.5% @ 15-Aug-2024	2.3
Meritor 3.25% @ 15-Oct-2037	2.2
Atlassian 0.625% @ 01-May-2023	2.2
Live Nation Entertainment 2.5% @ 15-Mar-2023	2.1
Workday 0.25% @ 01-Oct-2022	2.0

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 0.75%. 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. Standard Management fee schedule: First $25M 0.75%, Next $25M 0.70%, Next $50M 0.60%, Thereafter 0.50%.

Disclosure *(continued)*

From inception through December 31, 2017, the index presented for performance and characteristics comparisons was the Bank of America Merrill Lynch All Qualities All Convertibles Index (BAML Convertible Index). Beginning on January 1, 2018 the primary benchmark changed to the Thomson Reuters US All Cap Focus Convertible Index. The change was made retroactively to the inception of the strategy. The change was made due to the introduction of the newly created Thomson Reuters 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 beginning in 1994. Since the Thomson Reuters US All Cap Focus Convertible Index did not exist prior to 2017 there may be significant risk and return characteristic differences when compared to the index. To provide additional historical context, the BAML Convertible Index performance will be shown in addition to the new index. For more information on the index construction methodology, historical calculations or index change, please contact Nicholas at info@nicpartners.com. To provide additional historical context, the BAML Convertible Index performance will be shown in addition to the new index.

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.
account managers. No representation is given with respect to their accuracy or completeness, nor that the figures are necessarily GIPS compliant.

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