

## **Mohican Outlook**

The question is “Why should Mohican manage your money?” and the answer is “Because we focus strong talent on sustained opportunity.” What follows here is an introduction to Mohican thinking that supports this singular Q&A.

### **The Core Strength of Convertible Arbitrage**

The attractiveness of an arbitrage portfolio is that its performance profile is not based on forecasting market directions, but rather on an expected return to fair value of securities. However, many arbitrage strategies contain no driver for return to fair value, leaving the time frame for return to fair value highly uncertain and possibly very long. Option arbitrage, for example, lacks positive cash flow and incurs risk by relying on active trading to continually generate returns. Long/short strategies, like the equities they hold, contain no time frame for valuation that would act as a forcing function for a process of return to fair value.

Convertible arbitrage is unique because, within a specified time frame, the investor is assured of a return to fair value when the convertible bond matures on a predetermined, typically short-term, date. Prior to maturity, the security may be redeemed by the issuer or converted by the holder into the underlying short stock position, or the underlying company may be acquired or become bankrupt, but in all events the convertible is paid fair value in cash relative to its offsetting stock hedge within an identifiable, typically short-term, time frame. As a result, convertible arbitrage is a lower-risk, buy-and-hold strategy that carries less uncertainty than other "relative value" hedge portfolios as to when and whether the "undervalued" security will trade to its fair value (current supporting evidence appears under the next heading).

In addition, every convertible security is of a hybrid design that inherently controls risk by being diversified between bonds and equities. When the underlying stock depreciates, the bond depreciates less. When the stock price collapses, the bond price drops only to its straight-bond floor value. If the stock goes to zero, the bond nevertheless retains some recovery value. Of course, any reduction in bond price also increases the current yield and yield to maturity of the bond.

### **The Events of 2008 and Early 2009**

In late 2008, forced selling and negative returns were the chicken and egg of convertible arbitrage accounts. Investors withdrew from accounts to raise cash, liquidations in highly leveraged accounts destroyed demand for securities, prices of securities dropped, and returns turned sharply negative, and investors were encouraged to fully redeem in a downward cycle. Late last year, prime brokers doubled margin requirements and boosted

borrowing costs, further reducing the high leverage and associated high risk that some convertible bond hedge fund managers had relied upon to boost returns.

With demand for securities down, from mid September 2008 through early March 2009 only two new convertible issues came to market. Seven new convertible issues then appeared in the last three weeks of March. The two largest of these issues were priced extremely cheaply and traded up to their conversion prices within a week after issuance. Note that new convertible bond issues numbered about 350 in 2008 and 850 in 2007.

As of March 31, 2009, assets in hedge funds dedicated to convertible arbitrage were about half of what they were a year earlier and at the lowest level in nearly a decade. Meanwhile, after being at the bottom of the performance list for hedge fund strategies in 2008, (the worst year of performance in the history of convertible arbitrage) performance of convertible arbitrage in the first quarter of 2009 has been best among all (not just arbitrage) strategies. Hedge fund databases report gains of 7% to 10% for convertible arbitrage in Q1 2009 versus -1% to 2% for all other strategies, evidence of the strength of convertible arbitrage in returning to fair value.

### **The Results of Recent Events**

The convertible market today looks much like it did in the mid 1990's when large volume originated from long-only investors and hedge funds were niche players, a market that is ideal for arbitrageurs. Large and lasting opportunity has amassed in this market as a result of (1) an exodus of investors and managers from the strategy, (2) cheap merchandise with wide credit spreads, and (3) new issues with high coupons and low premiums. The outlook for convertibles is that they offer a long-term attractive combination of double digit yields and equity exposure with relatively low risk.

Convertible bond valuations are attractive to both credit and equity investors looking for additions or substitutions in their portfolios. Convertibles are not only a cheap proxy for exposure to the credit markets, but also a better alternative to equities by reason of their downside protection and upside potential. On the manager side, nearly two-thirds of all convertibles are neither distressed nor mainly equity-sensitive, offering wide opportunity to trade in a robust middle ground.

Pensions, endowments and institutions are restructuring their relationships with hedge fund managers to emphasize long term performance and gain better control of assets, often through managed accounts. Investors generally want low leverage, daily or weekly liquidity, and total transparency. A shift toward managed accounts will also allow both investors and managers to concentrate their skills and resources more efficiently.

### **The Outlook from Mohican**

Mohican is well positioned to exploit long-term opportunity in convertible arbitrage and will do so while managing risk with the same diligence that it has always practiced.

Mohican will continue to build on the core strength of convertible arbitrage by managing a portfolio with a unique blend of versatile trading, a focus on small/mid cap companies, and limited leverage. The Mohican approach to portfolio management is to protect assets, maintain a base of modest but positive returns, and pursue the best opportunities to enhance returns. We emphasize coupon bonds to generate yield, and increase returns through both convertible appreciation derived from credit tightening and stock trading opportunities based on volatility.

Mohican Financial Management, LLC has had zero turnover of management in its nearly seven year history. Convertible arbitrage has been and will be our only interest because it is a robust strategy and we're very experienced in it. We have built a stable, reliable firm that concentrates complex skills and sound style on the every-day task of delivering steady returns to investors. We serve investors in a managed account for a mutual fund, a managed account for a hedge fund platform, and a hedge fund with domestic and offshore feeders. We consider ourselves to be world class in convertible arbitrage with the simple objective of growing on that basis.

We're not speculative about the financial crisis, the worldwide economy, or the financial markets. We're just confident in our chosen investment strategy and our approach to it.