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207.878.3000 ■ 800.578.9981 ■ info@dows.com

CONVERTIBLE BONDS

On its surface, investing in convertible bonds may seem appealing. One hopes to enjoy the best of two worlds - the safety of a fixed income security, plus the appreciation potential of an equity. In practice, however, neither implementation of a convertible bond portfolio strategy, nor the results sought with such a strategy, are easily achieved.

THE PAUCITY OF QUALITY MERCHANDISE

The first reason is simply the shortage of quality merchandise. In a survey of the convertible bonds listed in a *Moody's Bond Record*, we discovered that there were just 44 domestic companies with convertible bonds outstanding that were listed on one of the major exchanges and which had a Moody's quality rating of at least an A. Of these 44 issues, there were just 4 for which the company's common stock carried *Value Line* "timeliness" ratings of #1 or #2 (while there were 12 that carried ratings of #4 or #5)

There are, in addition, five other critical parameters needed in screening convertible bonds to meet the particular investment objectives of any given portfolio. These are maturity, current yield, yield-to-maturity, the call provision, and the conversion premium. With just four bonds left in the above acceptable universe, there is not much of a chance that an appropriate combination of these latter factors is apt also to be found, and certainly not possible that they will be found in sufficient numbers to provide any degree of diversification.

WHY CONVERTIBLE BONDS ARE ISSUED

The foregoing observation is not particularly surprising, if one understands "why" companies that issue convertible bonds issue them in the first place. Convertible bonds tend to be issued by smaller, more speculative firms that find it difficult, because of risks inherent in their operations, to sell straight bonds or common stock at a reasonable cost. More often than not, convertible bonds represent the result of an effort to obtain financing that is not easily obtained in any other way. Prosperous companies generally do not finance their growth with new securities. They do their financing with internally generated profits. If internally generated funds are not adequate, companies will resort to straight, non-convertible debt, if possible. That is because they do not want to dilute their shareholders' equity. The convertible feature is tacked on to a bond as a "sweetener" when a straight, non-convertible issue would seem so risky to potential investors that the interest rate that would have to be paid to sell the bond would be exorbitant. The conversion feature makes the bond more readily marketable. In short, convertible bonds are usually issued by companies that are not doing particularly well, to help them get over their difficulties. Convertible bonds, too, are typically subordinate debentures which means that their standing, in the event of default, is lower than that of any other of the company's debt or even its bank loans.

CALL FEATURES: HEADS YOU LOSE, TAILS YOU DON'T WIN

Probably the most frustrating aspect of a convertible is its call feature - often overlooked in its evaluation. If interest rates should decline significantly after the convertible bond is issued, most companies can and will call their bonds, in which case one loses the source of what had been a relatively attractive income, and must then reinvest the proceeds in another vehicle at the then lower rates of interest. On the other hand, if interest rates go up, there is no chance that the bond will be called, and so the investor is stuck with a lower-than-market rate of interest on the bonds. This is an example of a "heads, you lose; tails, you don't win" type of investment.

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FOR THOSE WHO WANT TO OWN CONVERTIBLE BONDS, NEVERTHELESS

Investors determined to own convertible bonds, in spite of the foregoing observations, may find the following information useful:

In the Spring 1998 issue of *The CFA Digest*, there is an abstract prepared by Charles F. Peake of an article which appeared in the Fall 1997 issue of *The Journal of Portfolio Management* which, in turn, reported on a study by Craig M. Lewis, Richard J. Rogalski, and James K. Seward entitled, "The Information Content of *Value Line* Convertible Bond Rankings."

The essence of the study and article, according to the abstract, is that, while a *Value Line* common stock rating is very useful in evaluating the appreciation prospects of either a common stock or a convertible bond, a *Value Line* convertible bond rating, in evaluating a convertible bond, actually provides less useful information, and so is less valuable, than is the *Value Line* common stock rating for the same company.

AN ALTERNATIVE

As an alternative to convertible bonds, to the extent that one wants safety of principal and current income, it would seem preferable to own high-quality, fixed income securities which generally offer yields higher than those available on convertibles of comparable quality; and, to the extent that one wants the potential for appreciation, it would seem preferable to own high-quality, growth stocks which generally provide even greater appreciation than do the convertibles of the same or comparable companies. A package consisting of some combination of these two types of securities would seem much superior to a package of convertible bonds. Such a strategy is referred to as a "barbell." It allows the holder to weight the two types of security in any combination along the spectrum between a pure fixed income portfolio and a pure equity portfolio. In effect, the barbell approach enables one to create synthetic convertible bonds out of the best of each kind of security.

Let us suppose we are dog lovers and keep a kennel of a dozen dogs. We like both guard dogs and race dogs. Are we better served if we own six German shepherds and six greyhounds or if we cross the breeds and have twelve grey German shephounds?

Clifford G. Dow, Sr., CFA, CHFC, CFP®
Chief Investment Officer
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