PRIMER ON CONVERTIBLE BONDS

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A convertible bond is a hybrid security, with blended characteristics of fixed income and equity securities. The convertibles market is relatively small, making participation among individual investors difficult and pricing dynamics less attractive. These securities in their most basic form offer more risk/return potential, though understanding the sector can be complex. During low rate environments with high equity valuations, many financial advisors receive questions about convertibles. This piece can educate clients.

Current Market Size
The convertible bond market is fairly small as compared to the greater US corporate bond market. The $245 billion in convertible bonds outstanding from 890 issuers is a nominal portion of the $8.1 trillion in US corporate bonds outstanding from 5,371 issuers. In recent years, the size of the convertible bond market has shrunk as rates dropped and the cost of issuing debt over hybrid securities declined. Nevertheless, convertibles can be an intriguing portion of the market when available. The securities offer both debt- and equity-like features and risks. The securities can be used to limit interest rate risk, while at the same time increase credit risk, versus fixed income securities. Similarly, the securities can be employed to lessen downside market risk, but have decreased liquidity, versus equity securities. Note, however, that many convertibles are used primarily by institutional investors that want to hedge their equity exposure, so the ability for individual investors to participate may be constrained considering the supply/demand dynamics and market liquidity. In our discussion, we will mostly focus on the basic convertible bond structure known as “vanilla” convertible bonds.

Product Highlights
A convertible bond is a fixed income instrument that allows the holder to convert the bond into equity under specific conditions. The basic (“vanilla”) structure gives the holder the option to hold the bond until maturity and receive cash par value, or to convert the bond into a specified number of shares of stock of the same company. In a vanilla convertible, the holder of the security has the option to choose if and when to convert the bonds into equity, as determined by the security’s indenture. Convertibles are bonds with embedded options, and, as such, valuing them can be complex. Consequently, a convertible bond’s price reacts differently than interest rate movements and changes in the equity value of the underlying security depending on how likely it is that the convertible bond would be converted.

A few items to note about convertibles:

- **Coupon**: Because of the embedded option, investors sacrifice additional coupon versus straight bonds for a convertible bond. Investors buying the convertible bond at issuance theoretically value the option at or above the amount sacrificed in yield versus a straight bond.

- **Conversion Ratio**: This ratio dictates the number of common shares an investor would receive when converting the bond to stock. It is the price paid per share to acquire the underlying common stock through conversion. The greater the stock price, the fewer the shares the holder receives upon conversion. For example, for a $1,000, if the conversion price is $40/share, the conversion ratio would be 25 shares.

- **Conversion Premium**: This premium indicates the amount the conversion price exceeds the current price of the underlying stock. Using our prior example, if the security has a conversion price of $40/share, and the current market price of the underlying stock is $20/share, the conversion premium would be 100% (or $40/$20 – 1).

- **Initial Premium**: This premium refers to the amount the conversion price exceeds the price of the underlying stock on a convertible bond when the bond is first issued.

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• **Rank**: Convertible bonds usually rank subordinate to unsecured debt. At the same time, convertibles sit senior to common stock due to their debt-like attributes. Their values are often deeply impaired in the event of bankruptcy.

• **Bond-like Features**: Convertible bonds offer regular coupon payments, along with the return of principal at maturity, like nonconvertible bonds. Many convertible bonds, in addition to the convert feature, may have embedded call options by the issuer should interest rates fall. Also, in a situation where the stock price declines meaningfully, a convertible bond acts more like a bond without a conversion feature. The yield and price on the security will respond mainly to interest rates and the credit quality of the company.
  
  o **Busted Convertibles**: If the underlying stock of a convertible bond trades well below the conversion price, the convertible will act more like a debt than equity, as the probability of the bond being converted to equity before maturity is relatively low. Generally, the threshold of a busted convertible is when the stock is trading 50% below the conversion price.

• **Stock-like Features**: If the conversion price on a convertible bond is at or above the price of the underlying stock, the convertible bond’s price tracks movements in the equity value. Also, once an investor chooses to convert the bond into stock, the equity value experiences “dilution” due to the increased number of shares outstanding.

### Main Features and Risks of Vanilla Convertible Bonds

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<thead>
<tr>
<th>Features</th>
<th>vs. Bonds</th>
<th>Risks</th>
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<th>vs. Stocks</th>
<th>Risks</th>
</tr>
</thead>
<tbody>
<tr>
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<td>- Stock price volatility</td>
<td>- Lower downside risk (price floor)</td>
<td>- Decreased liquidity</td>
<td></td>
<td></td>
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<td>- Higher credit risk</td>
<td>- Dilution upon conversion</td>
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**Source**: Janney ISG

### Risks of Convertible Bonds

Convertible bonds have risks that are seen in fixed income and equity products, as well as some unique risks. The price of the security moves with the price of the underlying stock and with interest rate changes. Additionally, credit risk is a major component of convertibles. Issuers of convertible bonds are usually lower rated (mostly high yield, and often smaller) credits that want to access capital at a cheaper rate. Because of their exposure to equity and credit valuations, the credit quality of the issuer is important when reviewing the risk/return tradeoff of convertibles. If the issuer experiences a credit event, the price of the convertible could decline meaningfully both in response to movements in the underlying stock and on potential implications of credit risk. What’s more, when there is a credit event or negative pressure on the underlying stock, an investor’s ability to liquidate holdings of a convertible could be impaired, as the market for convertibles is likely less liquid than the market for the underlying stock. Noting that an investor gives up yield for the option to convert the bond into common stock, the potential return relative to a straight bond could be limited.

### Types of Investors that Purchase Convertible Bonds

There are several reasons an investor would purchase a convertible bond. The first is that the investor wants to limit the downside of buying an equity security through having the debt feature, while still benefiting from potential price appreciation. Secondly, an investor often times uses the convertible bond as an inexpensive way to buy a call option on a stock. The investor might short the stock and purchase the convertible to decrease downside, a hedging strategy known as convertible arbitrage. Third, an investor purchases a convertible to access a company that may not have other debt outstanding, given that many issuers of convertibles are lower quality credits that use the convert feature to entice investors.

### Conclusion

In this low-rate environment in which corporate bond new issuance is fairly accessible, many companies have shied away from offering convertible bonds. Only firms with high equity growth potential or with high credit risk have been using convertible bonds over other fixed income securities...

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income instruments to raise capital. Covenant requirements have been relatively light for fixed income securities and the relative cost between issuing a corporate debenture and a convertible is tight over historical levels. Nevertheless, investors should understand the basics of convertibles, particularly when looking at new names in which to invest. Before considering a convertible bond, investors should assess the risk/reward trade-off.

For More Information
Please contact your Janney Financial Advisor for more information on Convertible Bonds and to assist in evaluating whether Convertible Bonds fit within your investment goals.

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