OPEN- AND CLOSED-END CONVERTIBLE FUNDS

By Albert J. Fredman

With their dual stock-bond personalities, convertible bonds provide a smoother ride than the underlying equity; mutual funds that invest in convertibles are, in a way, similar to balanced funds, but they tend to hold securities of smaller firms.

The S&P 500 index has returned 17.5% per year on average since 1982 compared with 11% per year since 1926, according to Ibbotson Associates. The market's price-earnings ratio, dividend yield, and other valuation yardsticks signal richly priced equities, exposing investors to greater downside risk. In that kind of market environment, convertibles are a conservative common-stock alternative worth pondering. With their dual stock-bond personalities, convertible bonds (and preferred stock) provide a smoother ride than the underlying equity.

Both open- and closed-end funds specialize in this area. The assets of both groups total less than $9 billion. Load funds account for most of the money in the open-end group and only nine closed-end funds exist. Because of their hybrid nature, convertible funds rarely, if ever, appear on lists of top and bottom performers.

Convertible bonds, which are closer to an equity than a fixed-income investment, represent a tiny slice of the more than $10 trillion domestic stock market, amounting only to about $150 billion, with some 700 issuers. The typical issuer is a small, rapidly expanding company perhaps in the technology, healthcare, or consumer-goods sector. However, the market is not limited to smaller issuers, and also includes large, investment-grade issues from large companies such as Home Depot, International Paper, Microsoft, and Unocal. Measured in total market value, large, high-quality issues comprise about a third of the convertible market.

Mutual funds that invest in convertibles are, in a sense, similar to balanced portfolios that mix bonds with stocks. Both emphasize income and capital preservation along with appreciation, but convertible funds tend to hold securities of smaller firms in contrast to the large-cap issues found in traditional balanced portfolios. Thus, a typical convertible fund follows the small-stock cycle but with less volatility than a straight small-cap portfolio. Conversely, a large-cap balanced fund would track the S&P 500 more closely. The majority of convertible bonds also have lower credit ratings than the high-quality debt balanced funds normally favor.

The smaller company orientation common to convertible funds allows you to diversify away from the S&P 500, but with more income and less risk than a typical small-cap fund. While parts of the convertible market are much more efficiently priced than they used to be, the sector is similar to the small-cap arena with its moderate degree of inefficiency. Arbitrageurs such as hedge funds have taken a greater interest in exploiting mispricings, but good convertible managers can still add value.

HOW CONVERTIBLES WORK

A convertible bond or preferred stock can be exchanged for a company's common shares, often at the investor's option. The equity component of a convertible is basically an embedded call option on the issuer's common

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TABLE 1. RETURNS ON CONVERTIBLES COMPARED WITH THEIR UNDERLYING STOCKS

	Total Returns		Convertible Return
	Convertibles	Stocks	as a Percentage of Stock Return
Year	(%)	(%)	(%)
1997	18.4	21.1	87
1996	15.2	16.0	95
1995	24.0	24.4	98
1994	–4.8	–3.1	157
1993	19.0	23.2	82
1992	16.1	18.2	88
1991	31.4	38.7	81
1990	–4.1	–14.3	29
1989	11.4	9.6	119
1988	12.5	13.0	96

Source: PaineWebber Convertibles Research

stock. These hybrids have three basic attributes:

- An upside potential that normally is less than that of the underlying common stock because convertible buyers pay a premium for the conversion privilege.
- Less downside risk than the stock due to built-in price supports.
- A yield that normally is higher than that of the associated stock.

Table 1 contrasts the returns on the PaineWebber Convertibles Index with the returns on the underlying stocks over the past decade. In 1997, for instance, convertibles rose 18.4%, representing an 87% participation in the 21.1% total return on the underlying stocks. In that same year, convertibles exhibited only 57% of the stock's volatility. In a market environment where common stocks return 15% to 20% and interest rates remain relatively stable, convertibles participate in about 90% of the advance of the underlying stocks with 60% of the volatility, according to PaineWebber Convertibles Research.

Convertibles allow companies to sell common stock at a hoped-for higher future price, perhaps 20% to 25% above the stock's recent price. The "conversion price" is the per-share cost of the stock if you convert, and the "conversion ratio" is the number of shares you receive for, say, a $1,000 par bond. If a bond is exchangeable for 20 shares of stock, its conversion price would be $50 ($1,000 divided by 20). Most bonds are intermediate-term with a four- to 10-year maturity. The typical preferred stock has no maturity but is callable. Normally, convertibles are not outstanding as long as the usual straight bond. If all goes well, conversion might take place within a few years.

Below-investment-grade ratings, such as double-B or single-B, are common. As "junk bonds," convertibles face greater risk of loss. But a convertible has a lower coupon rate than an otherwise equivalent non-convertible issue because it offers holders the chance of participating in favorable equity performance. Yet a convertible often yields several percentage points more than the common stock, making it an attractive stock substitute.

Some convertibles act more like stocks whereas others behave more like bonds, depending on where the stock price is relative to the conversion price. When the common stock rises above the conversion price, the convertible also will rise, albeit at a lesser rate. When the common stock falls below the conversion price, the convertible behaves more like a bond providing a protective floor.

PRICE SUPPORTS

Support for a convertible's price is provided by the greater of its "conversion value" or its "investment value." Where a convertible trades relative to the two depends on the stock's price.

Investment value: A convertible's value as a straight debt issue, stripped of its conversion feature, depends on the yields paid on similar non-convertible bonds of the same credit-quality and maturity. For example, if ABC Company's 6% convertible debt matures in 10 years and otherwise comparable non-convertible issues yield 8%, the convertibles would have an $866 investment value. This price floor changes with variations in interest rates and the issuer's creditworthiness. Like regular bonds, convertibles can be hit hard by a surge in interest rates although the shorter maturities of most reduce their sensitivity to interest rate fluctuations.

Conversion value: A convertible's worth if converted equals the stock price times the conversion ratio. As illustrated above, the latter is the number of shares of common stock that each $1,000 bond can be exchanged into. If ABC's conversion ratio is 20 and the stock trades at $40, the conversion value equals $800 ($40 × 20). But with an $866 investment value, the issue would trade at a premium to conversion value due to its investment value floor. In addition, a convertible usually sells at a premium to investment value because it offers the chance, however remote, to participate in a stock's appreciation. Let's say this convertible trades for $950.

Going forward, suppose ABC common rises 50% from $40 to $60. The conversion value becomes $1,200 ($60 × 20). The convertible would appreciate from $950 to, say, $1,250, a 32% rise. The security typically trades at a premium above conversion value based upon factors such as the likelihood of a further increase in the stock's price. In this example, a 50% gain in ABC's price resulted in only a 32% rise in the

convertible because paying the conversion premium lessened the gain when the premium subsequently deflated.

Appreciation-minded investors prefer to buy at low conversion premiums for greater gains when the stock advances. Thus, convertibles selling at low premiums tend to act more like the stock—a highly equity-sensitive convertible selling at a small premium will move up and down to nearly the same extent as the stock. Of course, convertibles are callable, and the issuer would call the security to "force conversion" when the conversion value sufficiently exceeds the call price. Forcing conversion gets the bond or preferred off of the issuer's balance sheet. Remember that the objective was to sell stock.

At the opposite extreme, a convertible selling at a very high conversion premium—and at a relatively low premium to its investment value floor—acts much like a bond. This often happens when the underlying stock has tumbled and the value of the conversion privilege is way down. These so-called "busted" convertibles are purchased primarily for their yields, but they also may offer long-term capital appreciation potential.

NEWER MODELS

In addition to traditional, plain-vanilla convertibles, a variety of newer models with colorful acronyms such as DECS, PERCS, PRIDES, ACES, and STRYPES have become a significant part of the market. These customized models each have their own unique risk/reward characteristics. Most have a mandatory conversion feature, pay more income, have the full downside risk of the common, and cap your gains. For example, DECS (or dividend enhanced convertible stock) place a partial limit on the upside, pay a higher yield, and have less volatility than the common. Although DECS don't offer the downside price support of a traditional convertible, equity price declines are tempered by their higher yields. DECS provide a higher yield in exchange for a loss of a portion of the stock's upside. Conversion into common (or cash) is mandatory at maturity, which typically is in three to four years.

Zero-coupon convertibles trade at deep discounts to their face value and gradually appreciate over time. Unlike traditional zeros, they provide an equity kicker and can be "put" to the issuer on specific dates at prices reflecting the accretion of the implied interest return. The put feature limits an investor's losses because the zeros can be sold at a fixed, predetermined price, irrespective of how far the common stock has fallen. Most convertible funds hold a modest amount of these zeros as well as some of the other newer varieties.

SIZING UP THE FUNDS

Table 2 provides performance and other data for selected convertible mutual funds. The category averages are for all funds in the Lipper category rather than just those in the table. The open-end category is much larger than the six funds listed.

The differences in returns between different funds are striking. The closed-end returns are reported on a net asset value basis to be comparable with those of the open-end funds. Closed-end funds could be expected to perform about the same as comparable open-end funds when net asset value returns are compared. However, if you are able to buy a closed-end fund at a substantial discount you may be able to boost your market price return.

An index of stock prices should be used to gauge the performance of a convertible fund because convertibles are essentially an equity investment. Many convertible funds track their returns against the Russell 2000, whereas others might use the S&P 500, or the S&P MidCap 400. Because convertibles tend to behave more like smaller stocks, the Russell 2000 and the S&P MidCap 400 often are logical benchmarks. As you would expect, the average open- and closed-end convertible fund underperformed both the Russell 2000 and the S&P 500 during the bullish periods covered.

The total net assets column in Table 2 indicates that these funds are relatively small, with the exception of Fidelity Convertible Securities. Small portfolios are easier to manage in the small and moderately inefficient convertibles market. A fund with $1.5 billion in assets, for instance, would amount to about 1% of the $150 billion convertibles universe. However, the tiniest funds may have excessive expense ratios. (Higher expenses result in less net income and, therefore, smaller yields for shareholders). Note that the closed-end convertible funds have, on average, lower expenses and higher yields than do their open-end relatives.

STYLES DIFFER

Most convertible funds don't offer an equal blending of stock and bond characteristics. Some lean more toward stocks, others are closer to bonds. Some funds allocate a portion of their assets to the busted convertibles referred to earlier. The higher a fund's yield, the more it emphasizes the bond approach. For instance, the closed-end Putnam High Income Convertible and Bond Fund leans toward the bond style with high-yield non-convertible issues mixed in.

Convertible funds can differ in the size of company they target. The closed-end Lincoln National Convertible targets small, growth-oriented companies. Conversely, the Bancroft and Ellsworth closed-end funds prefer higher-quality, large-cap companies with a smattering of smaller ones mixed in. Both of these similarly managed funds keep about

90% of their portfolios in convertibles, which is well above the average of 75% for the closed-end convertible group, according to Thomas H. Dinsmore who co-manages both Bancroft and Ellsworth.

A major portion of the convertible market in terms of the dollar value of new issues in recent years has been the privately placed 144A issues. Individuals can't buy these relatively inefficiently priced securities, but fund managers can. SEC Rule 144A provides that these issues can be re-sold among qualified institutional buyers. Bancroft Convertible, Fidelity Convertible Securities, and Vanguard Convertible Securities are among the funds that recently had significant amounts of their assets in these restricted issues, according to Morningstar.

The tiny Matthews Asian Convertible Securities has a mid-cap value orientation and buys convertibles issued by firms in Asian countries, excluding Japan. Its currency risk is minimal because the majority of emerging Asia's convertibles are denominated in U.S. dollars. Because of their bond attributes, Asian convertibles have held up better than Asian equities in the region's tumultuous markets. However, if Asian stocks should rebound, Asian convertibles will lag because they have been trading on the basis of their bond values rather than their conversion values.

Gabelli Convertible Securities changed from an open-end to a closed-end structure on March 31, 1995. This was an unusual occurrence because it is much more common to see closed-end funds convert to open-end funds. However, convertible securities are often illiquid so the closed-end format makes sense. Gabelli also leverages its assets with an 8% cumulative preferred stock issue that amounts to about 24% of its assets and trades on the New York Stock Exchange. The

TABLE 2. INVESTMENT CHARACTERISTICS OF SELECTED CONVERTIBLE FUNDS

Fund	Net Asset Value Total Returns (%) (Through 12/31/97) 1 Year	3 Years	5 Years	10 Years	Total Net Assets ($ Mil.)*	Yield** (%)	Expense Ratio (%)
Open-End (Ticker)							
Fidelity Convertible Securities (FCVSX)	14.5	16.3	12.7	15.9	1,002.6	4.0	0.74
Gabelli Global Convertible Securities (GAGCX)	2.8	6.9	na	na	9.4	1.3	2.51
Lexington Convertible Securities (CNCVX)	13.2	12.1	8.7	na	10.3	0.8	2.38
Matthews Asian Convertible Securities (MACSX)	–23.2	–1.8	na	na	4.7	0.6	1.94
Value Line Convertible (VALCX)	17.0	20.0	13.4	13.0	85.6	5.2	1.03
Vanguard Convertible Securities (VCVSX)	16.4	16.2	10.9	12.7	186.7	4.6	0.67
Closed-End (Exchange: Ticker)							
Bancroft Convertible (A: BCV)	20.4	21.3	15.1	13.3	85.3	6.0	1.18
Castle Convertible (A: CVF)	12.1	16.8	12.5	12.5	62.1	5.7	0.99
Ellsworth Convertible Growth (A: ECF)	20.3	21.8	15.0	13.4	82.0	5.3	1.19
Gabelli Convertible Securities (N: GCV)	12.6	11.6	9.4	na	92.6	4.8	1.40
Lincoln Natn'l Convertible Secs. (N: LNV)	13.0	17.0	15.0	16.0	114.7	5.3	1.06
Putnam Convertible Opportunities & Income (N: PCV)	16.4	na	na	na	100.1	7.2	1.72
Putnam High Inc Convertible & Bond (N: PCF)	15.0	15.9	13.4	13.9	131.8	8.9	1.03
TCW Convertible Securities (N: CVT)	19.2	20.1	14.5	13.5	353.6	4.3	0.76
Van Kampen Amer Cap Convert. Sec (N: ACS)	17.0	16.8	11.2	11.0	78.6	5.2	0.77
Category Averages and Benchmarks							
All Open-End Convertibles	16.8	16.7	12.4	12.9	—	3.2	1.59
All Closed-End Convertibles	16.2	17.7	13.3	13.4	—	5.9	1.12
Russell 2000	22.4	22.3	16.4	15.8	—	—	—
S&P 500	33.4	31.1	20.2	18.0	—	—	—

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange

**As of 12/31/97*
***All yields are at net asset value as of 12/31/97.*
na = Fund not in existence for the entire period covered or a significant management change occurred during the period.

Source: Lipper Analytical Services, Inc.

preferred stock was issued to take advantage of the relatively low level of long-term interest rates and to try to earn an excess return for the common shareholders. The fund is obligated to pay a fixed $2 per share dividend to the preferred stock before any dividends can be paid to the common stock. Leverage amplifies returns as long as the portfolio's earnings exceed the fixed borrowing cost. However, the strategy compounds losses in unfavorable markets.

A number of closed-end equity funds are now using preferred stock to try to enhance investor returns. The only closed-end convertible fund using leverage, Gabelli Convertible, had about 49% of its assets in cash equivalents at this writing. In addition, the fund recently introduced a managed distribution plan in which it will pay out at least 8% of net asset value yearly to its common shareholders. The tiny open-end Gabelli Global Convertible Securities invests in both foreign and domestic issues. The fund recently had about 40% invested in the U.S., 36% in Europe, 12% in Asia and the Pacific Rim, 8% in Japan, and 5% in Latin America.

TABLE 3. CLOSED-END FUND PREMIUM (+)/DISCOUNT (–) RANGES

	52-Week Period 1/03/97 to 12/26/97		Extended Period 1/05/90 to 12/26/97	
Fund	**High (%)**	**Low (%)**	**High (%)**	**Low (%)**
Bancroft Convertible	–4.1	–16.2	+0.7	–17.7
Castle Convertible	–9.0	–17.3	+0.9	–18.3
Ellsworth Convertible Growth & Inc	–7.1	–17.5	–5.4	–17.5
Gabelli Convertible	–10.8	–16.4	+1.0†	–16.4†
Lincoln National Convertible Securities	–1.4	–14.0	+8.6	–17.8
Putnam Convertible Opportunities & Income	–0.6	–11.3	+0.8†	–16.2†
Putnam High Income Convertible & Bond	+13.4	+0.1	+13.4	–20.0
TCW Convertible Securities	+13.0	–1.3	+17.5	–5.6
Van Kampen Amer Capital Convertible Sec	–9.4	–19.1	–5.5	–19.1

†Life of fund; shorter than period listed
Source: Lipper Analytical Services, Inc.

BUYING AT A DISCOUNT

The size of the discount is a primary consideration with any closed-end fund. Table 3 contains discount-premium ranges for the nine closed-end convertible funds during 1997 and for an extended period. Note the wide discount-premium fluctuations, which present opportunities for astute investors. Discounts and premiums are reported weekly in the exchange-traded funds table appearing in The Wall Street Journal on Mondays and in Barron's. Daily discounts and premiums on many closed-end funds are now available on the Web from The Wall Street Journal's interactive edition and other Web sites. The wide availability of daily updates may make the closed-end arena more efficient, which should in theory lead to a modest narrowing of discounts.

The best strategy is to buy a closed-end fund when its discount is deep by historical standards and relative to its peers. But don't neglect factors such as management, performance, expenses, and liquidity. A deeply discounted fund might not be a bargain if it has subpar performance and an eye-popping expense ratio. Buying a closed-end fund at net asset value or a premium doesn't make sense because their more liquid no-load mutual fund relatives can be purchased at net asset value without a commission. If a sizable discount subsequently develops, performance will suffer.

Analyze the liquidity of a closed-end fund by tracking its daily volume. The higher the average share volume, the greater the liquidity. The purchase or sale of a block of shares that's large relative to a fund's normal daily volume can adversely impact its price, increasing the cost for a buyer or reducing a seller's proceeds.

CONCLUSION

A mutual fund focusing on convertible bonds offers a nice low-risk alternative to a small- or mid-cap growth-oriented stock fund. But the funds differ in various ways, so careful analysis is needed to find the most suitable one. Because of their income orientation, convertible funds rank relatively low in tax efficiency. Of course, a convertible fund may not be a necessary ingredient in your portfolio mix if you have allocated your assets appropriately. Invest only if you feel that the management can offer value. Even then, it is probably a good idea to limit your convertible allocation to no more than 20% of your investment portfolio.

Keep these points in mind if you decide to invest in a convertible fund:

- *Consider size.* The convertible market is relatively small, so small portfolios can have an edge. Think carefully before investing in a fund with more than $500 million in assets. But watch out for the tiniest funds with high expenses.
- *Identify the style.* What size companies does the management concentrate on? Does the fund focus on convertibles that act like bonds, stocks, or a blend? Higher-yielding funds lean toward the bond approach, but normally have less upside potential.
- *Determine the percentage of the*

portfolio invested in common stocks. A convertible fund must invest at least 65% of its assets in convertibles, but it could invest up to 35% in common stocks, straight bonds, or a mix. A typical convertible fund might have about 10% invested in common stocks. However, this percentage varies widely. The greater the stock weighting, the more a convertible fund will act like a stock portfolio with its higher and more volatile returns.

- *Compare performances.* Convertible funds should be compared with stock market benchmarks such as the Russell 2000, the S&P MidCap 400, or the S&P 500. Also compare a given fund with peers that appear to follow a similar strategy.
- *Evaluate management.* Good management is essential because the convertibles market is complex, relatively illiquid, and may offer inefficiencies. You want a management that has been at the helm long enough to establish a favorable performance record.
- *When investing in closed-end funds, buy at a discount.* As evident in Table 3, closed-end funds can experience wide fluctuations in pricing. Well-managed convertible funds offer excellent value at discounts of 10% or more, assuming their expense ratios are not out of line with the competition.
- *Watch the liquidity of closed-end funds.* Track the average daily volume and bid-asked spreads of closed-end funds you are interested in. Place a limit order to try to buy at the bid or sell at the asked or at some point between the two. ◆