

Convertible instruments offer investors enhanced opportunities for managing risk and pursuing wealth. Like stocks, convertibles typically offer upside appreciation in rising equity markets. As fixed-income instruments, convertibles provide income and potential downside protection in declining markets. Because of these hybrid characteristics, investors may look to convertibles for defensive equity or enhanced fixed-income allocations.

A convertible security is a bond or preferred stock that can be exchanged—or converted—into a specific number of shares of common stock, typically of the issuer’s company. The “conversion ratio” is determined at the time of issuance, and typically can be acted upon by the holder at any time. Convertible bonds are technically classified as debt instruments because they pay interest and have a maturity date. They are most often issued as subordinated debt and have default risk.

Convertibles have been used since the 19th Century, when railroads in the United States sold them to finance rapid expansion. Companies may find it particularly attractive to issue convertibles when volatility is higher in the equity markets (upward volatility typically benefits convertibles), in growth-oriented environments or during periods of higher interest rates. Lenders are willing to accept lower interest rates in exchange for the opportunity to take advantage of an increasing stock price.

Another type of convertible instrument is a “synthetic convertible.” Synthetic convertibles combine a non-convertible debt instrument with an option or warrant to create the characteristics of a convertible issue.<sup>1</sup> Synthetic convertibles may provide investors with enhanced opportunities to capture specific risk and reward characteristics.

Here and on the following page, we take a closer look at the basic characteristics of convertible bonds<sup>2</sup> and how they are valued. Keep in mind, this is just a starting point for illustrative purposes.

### Fixed-Income Characteristics

Convertible bonds represent a loan to the issuing company. They are typically issued at a par (face) value of \$1,000. During the life of a bond, interest is paid at a stated rate called the coupon. When the bond matures or is redeemed (also referred to as “called”) by the issuing company, investors are paid back the \$1,000 face value. Convertible bonds may also carry credit ratings assigned by a rating agency. Unlike traditional bonds, convertible securities offer the added attraction of upside potential due to their equity sensitivity (see below). Because of this, convertibles typically have lower coupons than equivalent non-convertible bonds.

### Equity Characteristics

Because convertibles can be exchanged for a specific number of shares of stock, they tend to gain or lose value along with the underlying stock. When the price of the underlying stock rises, the price of the convertible tends to rise as well. When a stock price falls, however, the convertible bond price typically declines only so far before its bond-like attributes establish a “floor,” even if the stock price continues to decline. While convertibles are thus sensitive to their underlying equities’ price movements, convertible investors—as bond holders—still receive the interest income and the principal repayment that bonds offer.

<sup>1</sup> Generally speaking, there are two main types of synthetic convertibles. A synthetic convertible unit is created by an investment manager who purchases the underlying components. A convertible principal-protected note is created by an investment banker, has the credit risk of a third party, and is sold as a complete package.

<sup>2</sup> While convertible bonds, convertible preferred stocks and synthetic convertibles all blend equity and fixed-income characteristics, there are differences among these instruments. In the discussion on this and the following page, references to convertibles will be to convertible bonds (which make up the majority of the convertible market).

## Valuing the Convertible

The value of a convertible security is affected by many factors, including the performance of the underlying stock, its volatility and coupon. The “Convertible Price Track” illustrations below show the theoretical relationship between a convertible bond’s price and the par value of the bond as the underlying stock price rises or falls.

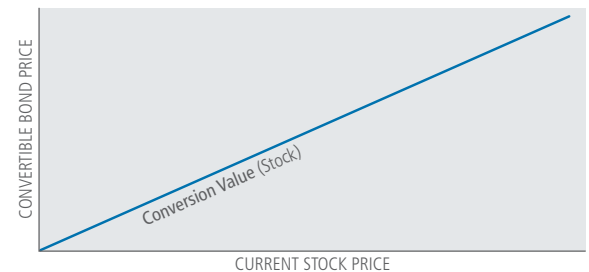
**FIGURE 1: INVESTMENT VALUE**

Investment value is the value of the convertible bond as if it were simply a straight bond without a conversion feature. The value of the bond at maturity is fixed. Hypothetically, holding everything else constant, the bond value stays relatively consistent over time and is not affected by changes in the issuer’s stock value unless the issuer approaches insolvency.



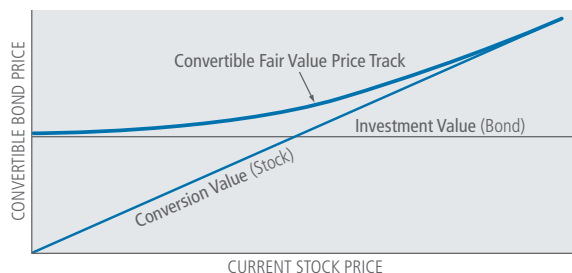
**FIGURE 2: CONVERSION VALUE**

The conversion value (sometimes called the equity value) is the stock’s current price times the pre-specified number of shares for which the convertible bond can be exchanged. Thus, the conversion value will move in tandem with changes in the stock price.



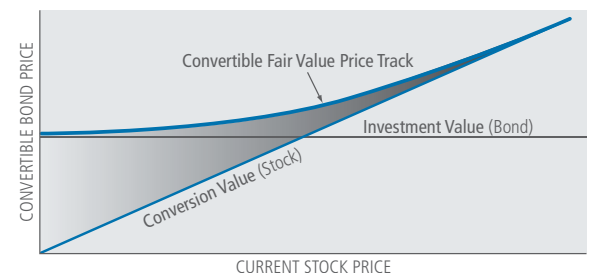
**FIGURE 3: CONVERTIBLE PRICE TRACK**

The convertible price track is the line representing the theoretical value of the convertible bond. It tracks the upward changes in the price of the underlying stock, yet is cushioned by the bond floor as the stock price declines. Should equity prices get quite high, the convertible is priced very similarly to its underlying equity. Conversely, when the underlying stocks are far below conversion value, convertibles are said to be “busted” and perform more like straight bonds. Thus, convertibles generally provide the greatest advantage to investors when they are in the middle range of the fair value price track, providing the potential for a combination of equity upside and bond-like downside protection.



**FIGURE 4: CONVERSION PREMIUM**

The conversion premium is represented by the shaded area between the equity value and the convertible’s fair value price track. This “conversion premium” is the premium an investor will pay over a “straight” bond price, representing the value offered by the convertible’s option to be converted into common stock.



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These are theoretical examples and not representative or predictive of any convertible instrument.  
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There are certain risks associated with an investment in a convertible bond, such as a default risk (the company issuing a convertible security may be unable to repay principal and interest) and interest-rate risk (the convertible may decrease in value if interest rates increase).