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Convertible Bonds Get Lift From Stock Rally

By TELIS DEMOS

Sales of convertible bonds are booming, as investors seeking to benefit from the roaring U.S. stock rally rush to purchase debt that can convert into shares.

Sales of the hybrid instruments in the U.S. have surged this year to \$38.3 billion from \$18.7 billion by this time in 2012, on pace for their largest full-year total since 2010, according to Dealogic.

Companies have sold 116 convertible issues, the most by this point in the year since 2007. Yahoo Inc. this week sold \$1.25 billion of convertible bonds that pay no interest but offer investors a chance to own the company's shares after a 50% rally, in one of the largest convertible deals of the year.

Investors, bankers and companies attribute the flood of offerings to a combination of rising share prices, higher interest rates and a gradually expanding U.S. economy. The dynamics make investors hungry for securities that in many cases provide some income now along with

the opportunity for share-price gains down the road. Bonds held to maturity rarely offer such so-called capital appreciation.

"What I'm looking for here is the upside participation in Yahoo stock," said Eli Pars, co-portfolio manager of the global convertibles fund at Calamos Investments. The firm managed \$28 billion in assets as of October. "You're giving up some income in exchange for the equity option."

Shares of Yahoo, a Sunnyvale, Calif., Internet media company, rose 65 cents, or 1.8%, to \$36.26 Thursday, putting the stock up 79% for 2013. The Dow Jones Industrial Average rallied 109.17 points to 16009.99, putting it up 23% for the year and marking its first close above 16000.

At the same time, some observers see the embrace of convertible debt on terms very favorable to companies as the latest example of some investors taking on risks that could boomerang should the market environment darken.

"This is part and parcel with a world that is

willing to take increasing amounts of risk for marginal returns amid ultralow interest rates," said David Puritz, portfolio manager at BlueMountain Capital Management LLC, a private investment firm in New York.

Issuers like selling convertibles because they typically offer low interest rates. Many observers expect interest rates to rise as the economy strengthens, driving up borrowing costs.

What's more, investors have been increasingly willing to accept terms favorable to the issuers of the notes, in the form of lower interest rates and higher thresholds for stock conversion.

New convertibles paying interest rates below 2% have jumped to 67% of the U.S. market in October from 15% in the same month a year ago, according to Prospect News, a New York-based market newsletter and data service. The proportion of low-yielding debt has increased as the yield on the 10-year U.S. Treasury note has risen by about a percentage point over the same period to a

recent 2.80%.

Bonds that convert only if the stock jumps more than 40% are making up about a third of the market so far in the fourth quarter, versus less than 20% a year ago, the figures show.

"As rates are rising, a lot of companies are looking to convert," said Santosh Sreenivasan, head of U.S. equity-linked capital markets at J.P. Morgan Chase & Co. He said strong demand has enabled issuers to reduce the amount they pay and increase the amount the stock must rally before the bonds convert into shares.

The bank was the lead agent on Yahoo's offering this week. The Internet company increased the size of its five-year offering from \$1 billion and decided to offer no interest after initially proposing a rate as high as 0.5%.

Yahoo's convertible note was only the second in the U.S. this year to pay zero interest. The other was an offering by ServiceNow Inc., a software firm, which came earlier this month.

*Portfolio holding as of 11/30/2013

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