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INVESTING

Convertible Bonds Can Smooth Volatility

ONSERVATIVE investors face a conundrum: Since markets have soared in recent years, it may be time to trim some stock exposure. But shifting to traditional bonds carries risks as rising rates threaten fixed-income holdings.

Part of the solution may lie in an often-overlooked investment: convertible bonds. These hybrid securities combine bond-like traits with some potential for stock market gains. Like traditional bonds, they typically offer fixed coupon payments and promise repayment of principal at a set maturity date. But they also give investors the option of converting the bond into a predetermined amount of the issuer's stock.

For conservative investors, convertible bonds can add valuable diversification and help smooth the ups and downs of a traditional stock-and-bond portfolio. "You want them to be a sea anchor to help the portfolio maintain less volatility," says Rich Howard, co-manager of Prospector Capital Appreciation Fund, which devotes roughly 20% of assets to convertibles. In rocky markets, the bond value acts as a floor, limiting the downside risk. What's more, because convertible bonds are tied to shares of common stock, they have historically proven less vulnerable than traditional bonds when interest rates rise.

These securities aren't risk-free. Issuers often have lower credit quality, and investors run the risk that they'll default on the debt. They're complex to analyze and trade—making investment through a mutual fund or exchange-traded fund a better bet. And investors in recent years have complained of slim pickings in the convertible market, as rock-bottom interest rates made it more attractive for companies to issue traditional debt. But that's beginning to change as interest rates tick up: U.S. convertible bond issuance totaled \$25.8 billion in the first nine months of this year, up more than 70% from the same period in 2012, according to market-research firm Dealogic.

Acting Like a Stock—and a Bond

A big selling point for convertible bonds: They can behave more like stocks when stocks go up

and more like bonds when stocks go down. If the underlying stock is trading well above the conversion price, the convertible will perform much like shares of that stock. If the stock is trading well below the conversion price, the conversion feature has little value and the convertible will trade more like a bond. "You're looking to collect the coupon while you wait for something good to happen in the equity that would provide your upside," says Wayne Anglace, co-manager of the Delaware Dividend Income fund, which devoted about 14% of assets to convertibles at the end of September.

Although issuers generally offer lower coupons on convertible bonds than they would pay on plainvanilla debt, money managers say they're finding convertibles with yields that look attractive compared to stock dividend yields and many traditional fixed-income investments. In the Delaware fund, for example, the convertible holdings yielded 3.5% at the end of September, Anglace says, compared with just over 2% for Standard & Poor's 500-stock index and 2.6% for the ten-year Treasury.

While convertibles aren't immune to rising rates, their ties to equity prices have helped them weather interest-rate hikes relatively well. Calamos Investments recently looked at nine periods over the past 20 years when the ten-year Treasury yield rose one percentage point or more. Convertibles delivered negative returns in only one of those periods and posted double-digit gains in six, while a broad bond-market index suffered losses in all nine periods.

One way to incorporate convertibles into your portfolio: Add a small dose (perhaps 10% or so) of a stand-alone convertible fund, an allocation that can reduce the risk of a standard stock-and-bond portfolio without reducing expected returns, studies show. Morningstar counts just 16 mutual funds in the under-the-radar convertible market. But one of the category's oldest funds, Calamos Convertible, just reopened to new investors in September. K—ELEANOR LAISE

Convertible Fund



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Fund Ticker Symbols

A Shares

B Shares CALBX C Shares CCVCX

I Shares

Important Risk Information: An investment in the Fund is subject to risks, and you could lose money on your investment in the Fund. There can be no assurance that the Fund will achieve its investment objective. Your investment in the Fund is not a deposit in a bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency. The risks associated with an investment in the Fund can increase during times of significant market volatility. The Fund also has specific principal risks, which are described below. More detailed information regarding these risks can be found in the Fund's prospectus.

The principal risks of investing in the Calamos Convertible Fund include: convertible securities risk, synthetic convertible instruments risk, foreign securities risk, caulity securities risk, interest rate risk, credit risk, high yield risk and portfolio selection risk. BofA ML All U.S. Convertibles Index (VXA0) is comprised of approximately 700 issues of only convertible bonds and preferreds of all qualities. Value Line Convertible Index is an equally weighted index of the largest convertibles. Set 500 Index is generally considered representative of the U.S. stock market. Lipper Convertible Securities Funds invest primarily in convertible bonds and/or convertible preferred stock.

As a result of political or economic instability in foreign countries, there can be special risks associated with investing in foreign securities, including fluctuations in currency exchange rates, increased price volatility and difficulty obtaining information. In addition, emerging markets may present additional risk due to potential for greater economic and political instability in less developed countries.

Before investing, carefully consider the Fund's investment objective, risks, charges and expenses. Contact 800.582.6959 for a prospectus containing this and other information. Read it carefully.



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