



Special Report

Revisiting the Case for Convertibles

June 3, 2009

Kevin Klarnet, CFA
Director
Convertible Securities

Elliot Stiefel, CFA
Managing Director
Convertible Securities

For more information, please contact:

Bruce Deutsch, Managing Director
201-585-5466
bdeutsch@palcap.com

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When we first wrote about the opportunities in convertible securities in October 2008, the convertibles market was in disarray. Falling stock prices and a widening of credit spreads had dragged down convertible security prices. The Option Adjusted Spread over Treasuries for the Merrill Lynch High Yield Master II Index was 1536 basis points on October 10, 2008 as compared with 592 basis points at the start of 2008. **The primary drivers responsible for the sell-off in convertible securities included:**

- **A Ban on Short Sales of Financial Stocks:** A disruptive ban on short selling of financial stocks was instituted on September 19, 2008. This ban prevented the establishment of new convertible hedge positions in financials, which by definition involve short sales as well as the dynamic hedging of existing positions. Holders of existing convertible arbitrage positions in financials aggressively sold into a market with no hedge buyers. Prices of their securities plunged.
- **Mass Redemptions by Convertible Arbitrage Funds:** Heavy losses for the convertible arbitrage strategies resulted in mass requests for redemptions from hedge funds. Convertible arbitrage managers were forced to sell into a market with few buyers and as a result, convertible prices fell precipitously. This sell-off in convertibles caused prime brokers to become increasingly concerned about the level of leverage inherent in the strategy. Consequently, many prime brokers forced their clients to reduce leverage, and in some cases, eliminate it entirely. This, in turn, resulted in more forced selling. The convertible arbitrageur, long the dominant player in the market for convertible securities, was being forced out of the game.
- **No New Issuance of Convertible Securities:** The market for new issues was effectively closed as a result of the pressure on the convertible securities market. Convertible arbitrageurs had long been the clearing force in the new issue market. As these buyers disappeared, there were not enough “long convertible players” to absorb the supply. There was simply too little demand to support the issuance of new convertible securities.

Fourth Quarter 2008 Performance

Convertible securities outperformed common stocks as represented by the S&P 500 Index in the fourth quarter of 2008. The Merrill Lynch All US Convertibles Index fell by 18.6% while the S&P 500 Index fell by 21.9%. Convertibles participated in 85% of the downside movement in common stocks. We view this correlation as unusual, as our expectation is that convertibles generally participate in less than 50% of a decline in the price of equities.

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Speculative convertibles (convertibles rated BB+/Ba1 or lower and not including non-rated securities) fell by 28.1% in the fourth quarter of 2008. Perhaps more interesting was the plethora of high yielding convertible securities with solid balance sheets and manageable credit profiles with yields-to-maturity of between 10% and 30%. We saw yields that could only be described as representative of a once-in-a-generation opportunity. Investors could buy a high yield convertible bond yielding 20% (or more) to maturity and get a “free option” to buy the underlying stock.

Convertibles Were Cheap and Yields Historically High

When we published “The Case for Convertibles” in the fourth quarter of 2008, convertibles as an asset class were statistically inexpensive with the average convertible price approximately 4.9% below fair value. Many convertibles were much cheaper as investors had fled the most speculative securities. The yield-to-maturity of the convertible securities universe climbed to 7.4% while speculative convertibles yielded 10.9%.

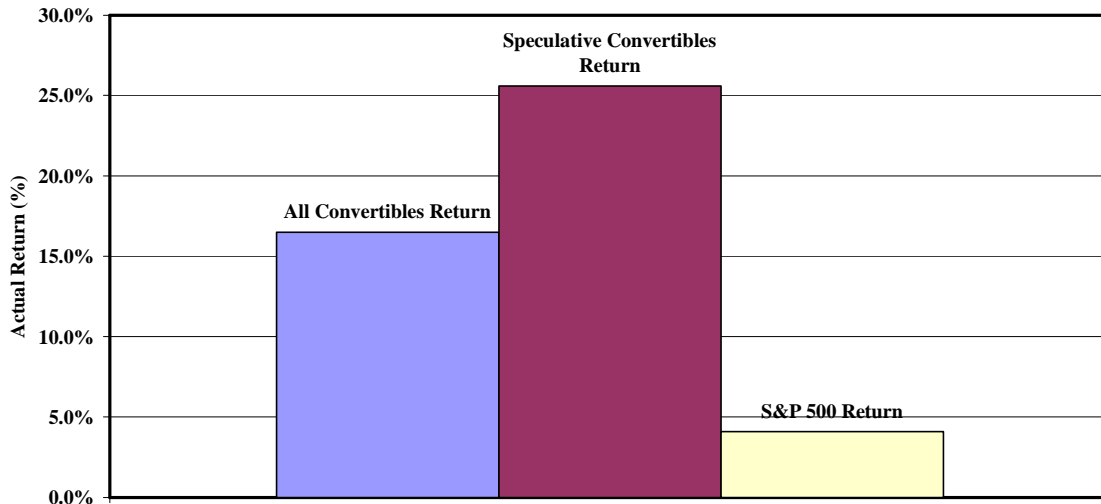
Convertible Performance Since Publishing “The Case for Convertibles”

Our timing may not have been perfect, but our recommendation to consider an investment in convertible securities was prescient. An investment in convertibles initiated on the date that we published “The Case for Convertibles” (October 10, 2008) would have returned 16.5% based on the return of the Merrill Lynch All US Convertibles Index through May 31, 2009. Stocks, as measured by the S&P 500 Index, advanced just 4.1% over the same period.

We believe that the superior performance of convertibles versus stocks over the observation period was largely due to the tightening of credit spreads. From the time of our initial posting through the end of May 2009, high yield option adjusted credit spreads derived from the Merrill Lynch High Yield Master II Index narrowed by 366 basis points, from 1536 bps over Treasuries to 1170 bps over Treasuries. Over that same period, the Merrill Lynch All Convertibles Speculative Quality Index soared by 25.6%, as investors responded to high yields.

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Convertible Performance versus the S&P 500 Since the Original Case for Convertibles was Published (October 10, 2008-May 31, 2009)



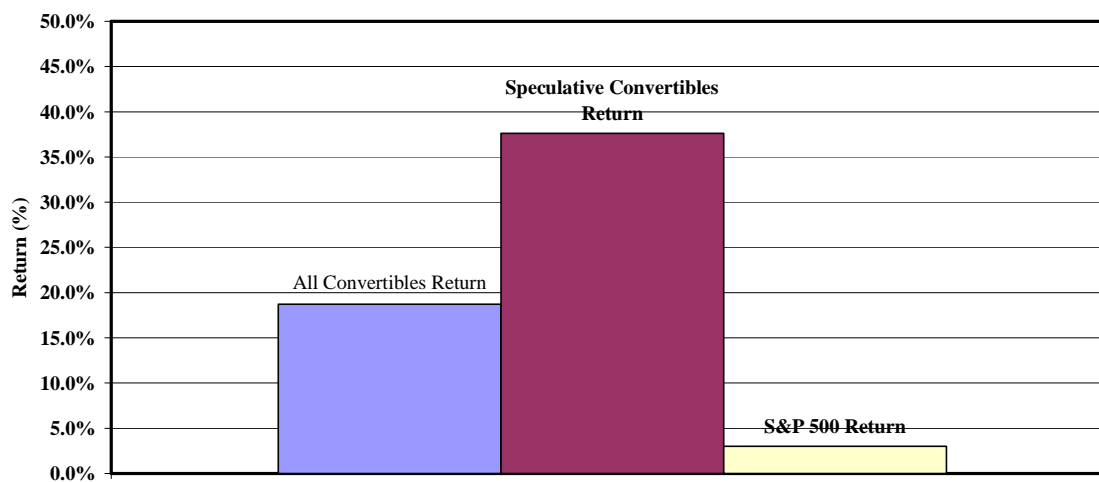
*Convertible return is the return of the Merrill Lynch All US Convertibles index for the period of the study.

Speculative Convertibles Have Been Strong in 2009

The first five months of 2009 have been difficult for the financial markets, and the period has included a new stock market low for the decade. Convertibles though, have performed quite well, far exceeding the performance of equities. The Merrill Lynch All US Convertibles Index advanced by 18.7% through the end of May. By comparison, the S&P 500 Index rose by 3.0% over the same period. Once again, and even more striking, was the performance of the All Convertible Speculative Quality Index, which rose by a staggering 37.6% over the period. This performance was boosted by considerable interest in speculative convertibles as high yield spreads narrowed.

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Year-to-Date Convertible Returns versus the S&P 500 Period Ending May 31, 2009



*Convertible return is the return of the Merrill Lynch All US Convertibles index for the period of the study.

The Convertibles Market Has Healed

The convertibles market has recovered from some of the factors that pressured prices last year. The ban on short sales of financial stocks has been lifted; convertible arbitrageurs can once again trade in a sector that has been very volatile and represents more than 20% of the convertible universe. The waves of redemptions that forced hedge fund sales appear to have abated. Capital committed to convertible arbitrage strategies is likely smaller than the commitment prior to last year's turmoil. The participants who are left are probably less leveraged and not as likely to make distressed sales if the market comes under pressure again. Before last year's convertible correction, convertible arbitrageurs dominated the space. Our conversations with the brokerage community suggest that there has been a resurgence of long-only participants. It appears that the convertible market is more balanced than it has been in several years.

There is Still a Strong Case for Convertibles

The opportunities discussed above have attracted new players to the convertible marketplace. **Convertibles are still a good value as they are 3.5% below their theoretical fair value as of May, 31, 2009. High Yield investors have discovered that many convertibles have both high yields and offer the added benefit of equity participation.** Equity Income funds have recognized the opportunity for higher yields than those of common stock and increasing equity participation as the underlying stocks

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move up. These “cross-over” buyers have helped to diversify the participants in the convertible market.

Companies Clean Up Balance Sheets by Issuing New Convertibles

Many companies are seizing the opportunity to clean up their balance sheets by repurchasing convertibles that are trading at a deep discount to par. They are also selling new convertible securities to finance upcoming maturities that investors have seen as a threat to companies with insufficient cash to satisfy their obligations. Companies are also selling equity to enhance their balance sheets and to provide a greater equity cushion under their debt.

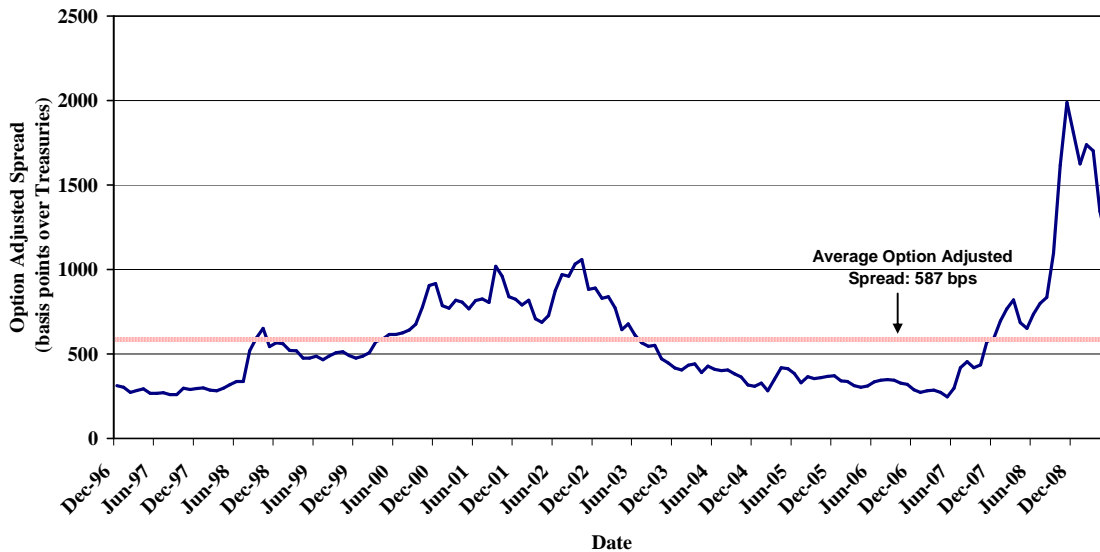
The New Issue Market Has Reopened

The new issue market has reopened following a six month hiatus. **Many well known companies have come to the convertibles market where they can issue debt less expensively than in the straight debt (non-convertible) market. The investor gets a relatively high level of equity participation in exchange for a lower coupon.** Convertibles, which yield 4.6%, as of May 31, 2009, still offer a higher yield than common stock (the current yield on the S&P 500 Index is 3.1%), and most have higher yields than Treasuries of similar maturity. The new convertible securities are often priced at a 5% (or greater) discount to their fair value as estimated by conventional convertible models. They often trade at a premium to par on the first day of trading.

We believe that the re-emergence of a new issue calendar could further benefit the speculative convertibles that have performed so well since we recommended a fresh look at convertibles late last year. The Option Adjusted Spread for high yield bonds over Treasuries is still quite high at 1170 bps as of May 31, 2009. By comparison, this spread was 592 bps in December of 2007. We believe that these spreads have considerable room for further contraction as illustrated in the graph below. As a result, we are still actively participating in the market for speculative convertibles.

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Option Adjusted Spread Over Treasuries for the
Merrill Lynch High Yield Master II Index*



*The spreads for high yield bonds are for illustrative purposes only. These spreads are not option adjusted spreads for convertibles.

Source: Merrill Lynch High Yield Bond Research

Conclusion

The convertibles market has shown significant signs of healing since our October 10, 2008 “Case for Convertibles”. While the explosive gains in the prices of convertible securities since our recommendation are not likely to be repeated, there are still ample opportunities across the convertible space. Many speculative convertibles still yield more than 10%. Companies are issuing new debt, retiring old debt and issuing equity to strengthen balance sheets. Some high yielding convertibles could be repurchased by, or eventually put back to, the issuing company. The potential for equity participation has increased as stocks have moved higher and convertible deltas (a measure of equity participation) increased. There are still some convertibles that offer exceptionally high returns. We believe that we will return to a market with the characteristics that outperformed equities, as measured by the S&P 500 Index, over the preceding 1, 3, 5 and 10-year evaluation periods. **Convertibles returned 7.7% over the preceding 20 years which equaled stocks, as measured by the S&P 500 Index. Convertibles delivered this performance with lower volatility than stocks in each of the periods evaluated.** (Please see the following tables). We continue to believe that the case for convertible securities is compelling and expect that they will once again deliver total returns that compete favorably with equities, but with less volatility.

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Annualized Returns of Convertibles Versus Equities

(Period Ending May 31, 2009)

	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Convertible Returns*	18.7%	-24.2%	-4.9%	-0.5%	2.4%	7.7%
S&P 500 Returns	3.0%	-32.6%	-8.2%	-1.9%	-1.7%	7.7%

*Convertible returns as measured by the Merrill Lynch All US Convertibles Index

Source Merrill Lynch Convertible Research

Annualized Volatility of Convertibles Versus Equities

(Period Ending May 31, 2009)

	YTD	1 Year	3 Years	5 Years	10 Years	20 Years
Convertible Volatility*	NA	27.2%	17.3%	14.2%	14.6%	12.5%
S&P 500 Volatility	NA	27.8%	18.7%	15.4%	16.1%	15.0%

*Volatility of the Merrill Lynch All US Convertible Index.