Value Line®

PRODUCT GUIDE

Issue Size: 3.10 mil. shrs. **Industry:** Bank **Rank:** 2
Cusip: 060505682 **Exchange:** NYSE **Common Rank:** 3

Equity Data	
Market Cap:	$181437.68 million
Debt Ratio:	51.76
Earnings / Share:	$0.90
P/E Ratio:	19.03
Rel. Volitility:	130%
52 week high:	$18.21
52 week low:	$14.84
Dividend Yield:	0.23

Convertible Information	
Current Yield:	6.50%
Yield to Maturity:	%
Maturity Date:	
Yield Advantage:	6.30%
Conve	
Rel. Vo	

The Value Line Convertibles Survey

Smart research. Smarter investing.™

TABLE OF CONTENTS

CHAPTER

1

Getting Started

Welcome to *The Value Line Convertibles Survey*, where at the click of a mouse, you get a daily analysis and evaluation of the more than 550 convertible securities covered in our database.

Once you are at the Value Line Home Page (www.valueline.com), sign in using your User Name and Password. After logging in, you will be brought to the "Welcome" page where you will find a link to your *Convertibles* subscription below. By clicking the "Dashboard" link on the main menu bar above (or the link found below in the Welcome Page), you will be brought to the main Value Line page, where you can also find a link to the *Convertibles Survey* in the movable "Quick Links" module in the right column.

LOOKING UP CONVERTIBLES

If you know the name of the security or the underlying common stock ticker, enter it in the "Lookup Convertible" data entry field (the white rectangle) on the right of the screen (e.g. "Helix Energy" or "HLX") and click the button labeled "Go" to the right of the rectangle.

The convertible, along with some basic information, will appear in the window below. Here, you can click on the convertible's name to get a snapshot of the information on one page.

Clicking on the "Analysis" tab on the lower left will give more information regarding this convertible.

Click on the "Printer friendly version" link beneath the "Snapshot" and "Analysis" tabs for a printout of all of the information on one page.

SCREENING OUR DATABASE

You also have the ability to tailor your search. By selecting the "Screener" tab near the top of the page and clicking "Rankings" and/or "Analysis" to reveal their data entry fields, you can filter our universe based on a number of criteria, such as Common Stock Rank, Convertible Rank, Timeliness or Performance, Investment Grade, Premiums, and Yields. For example, you can show only results that have a current yield greater than 16% or a conversion premium of less than 20%.

NEED HELP?

If you need assistance or technical support, call **1-800-VALUELINE** (1-800-825-8354) or email us at vlsoft@valueline.com. Our account managers are available to assist you Monday through Friday, 8:00 AM to 6:00 PM Eastern Time.

CHAPTER

2

Getting Familiar With Convertibles

OVERVIEW

A convertible is either a bond or a preferred stock that may be exchanged for another security, usually the common stock of the issuing company. Generally, no payment is required to effect conversion other than the surrender of the bond or the preferred stock. Normally the conversion privilege lasts for the life of the bond, or for the life of the preferred stock, though in a few instances, the number of shares of common stock for which the convertible can be exchanged may change. Certain conditions, such as trading volume and corporate actions can affect the convertibility of an issue. Convertible preferred stocks and convertible bonds (or debentures) are basically alike with the exception that preferred stocks represent equity in a company whereas bonds represent debt.

The following examples illustrate how bonds and preferred stocks are designated in *The Value Line Convertible Survey*:

(a) **Protein Design 2.75s2023 cv deb** — This 2.75% convertible bond (or debenture) pays $27.50 annually with a par $1,000 face value and matures in the year 2023.

(b) **Hilltop (Afford Residential) 7.5s2025 cv deb** — This 7.5% convertible bond (or debenture) was issued by and is the obligation of Afford Residential Corp. It pays $75.00 in interest annually with a par $1,000 face value and matures in the year 2025, but converts into shares of Hilltop Holdings.

(c) **KeyCorp $7.75 cv pfd** — This convertible preferred pays $7.75 in dividends annually.

Convertibles are a cost-effective method for companies to raise capital.

Convertible bonds and convertible preferred stocks are usually sold by corporations when other means of raising money would be more expensive. The conversion feature is a "sweetener" to persuade investors to accept a rate of interest on a bond or a dividend on a preferred stock that is below prevailing yields for comparable risk levels. If the stock rises in value, the value of the convertible will rise with it, as long as the conversion value is greater than the estimated investment value "as a bond".

A convertible's value is two-fold.

A convertible's value is drawn from both its conversion privilege (thus, dependent on the price of the underlying stock) and from the value it commands simply because it's a bond or a preferred stock. Although its price rises with its conversion value (i.e., with a rise in the stock), its price will normally fall no lower than its investment value.

Most often, however, convertibles will usually sell at premiums above both conversion and investment values. When you can buy a convertible at its investment value, you get the conversion privilege free of cost. By the same token, when you can buy a convertible at its conversion value, you get the investment value feature free of cost.

The benefits of convertibles over common stocks.

- Convertibles are less risky.
- Convertibles almost always provide greater income.
- Fairly priced convertibles are almost always favorably "leveraged." (That is, they will rise more than they will fall on an equal move, up or down, in the price of the common stock.)
- Over longer periods, convertibles have consistently outperformed common stocks when both income and price appreciation (i.e. total return) are measured. When the market rises swiftly, however, convertibles will generally lag the common stock.

COMMONLY USED TERMS

Conversion Ratio: The number of shares of common stock for which the convertible can be exchanged.

Conversion Value: The value of a convertible if converted into the common (i.e., the price of the stock multiplied by the conversion ratio). For example, if the conversion ratio is 5.0 and the stock is $20, the conversion value is $100.

Premium over Conversion Value: The percentage by which the price of the convertible exceeds the conversion value. Example: If the convertible price is 120 and the conversion value 100, the premium over conversion value is 20%.

Investment Value: The price at which the bond would likely trade if it were not convertible. In other words, the price at which a "straight" (non-convertible) bond or preferred stock of similar terms and maturity would trade.

Premium over Investment Value: The percentage by which the price of the convertible exceeds its investment value. Example: If the convertible price is 120 and the investment value 80, the premium over investment value is 50%.

Call price: The price the convertible may be called at, if it is callable. (See "Hard-call" protection and Provisional call protection.) **Note:** When an issue is called, holders have a certain number of days to decide whether or not to convert.

Hard-call Protection: Most convertibles, at issue, will be protected from being called before a certain period of time. Hard-call protection means that the issue cannot be called for any reason during the specified period.

Provisional-call Protection: A convertible that has provisional-call protection can be called only if the underlying stock rises to the predetermined price and remains at that price, or higher, for the number of days specified in the indenture.

Coupon/Dividend: The yearly interest or dividend paid on a bond or preferred stock. Bonds are almost always issued with a par value of $1,000, the price at which they will be redeemed at maturity. So, a bond with a 6% coupon pays $60 in interest annually. A preferred stock pays the dollar amount indicated in the name of the issue.

CHAPTER

3

Why Convertibles Are Safer Than Stocks, Yet More Profitable

Risk typically increases with potential return. To achieve higher returns, one normally needs to take on greater risk. There are, however, certain investments that historically have thrown off larger returns in proportion to risk than would be expected. Convertibles fall into that category.

Less risky than stocks.

It is easy to understand why convertibles are less risky than common stocks. First, they enjoy priority in terms of distributions (income): If a company's earnings decline, it might skip its common dividend, but would discontinue paying bond interest or preferred dividends only as a last resort. For if it did, bond and preferred holders could gain some control of the company. Furthermore, if a company fails, bond and preferred holders get paid off before common stock owners. In addition, convertibles almost always offer a higher yield than stocks. So, if the price of the common falls, the higher yield helps support the price of the bonds and preferreds.

What this means is that fairly priced convertibles are usually"favorably leveraged." Leverage describes the price movement of one issue relative to another. A convertible almost always moves more slowly than its underlying stock. An issue described as "favorably leveraged" will rise more on an increase in the underlying stock than it will fall on a decline of the same magnitude in the stock. Convertibles are usually favorably leveraged since they are free to participate in a rise in the stock, but their higher yields limit the extent of any drop.

Convertibles often outperform common stocks.

Studies show that convertibles consistently outperform common stocks over periods of five years or more. Why this should be so is best explained if we look at what happens in various phases of the market. When the market falls, it's easy to see that convertibles will do better. Not only do they fall less, but they also provide greater income. In a flat market, their greater income is the deciding factor. In a rising market, convertibles do not normally appreciate in price as fast as the common, but if the market rise is gradual, the greater income from convertibles causes the total return from convertibles to equal or exceed the total return from common stocks. Only in a rapidly rising market do convertibles fall behind. That convertibles have historically outperformed common stocks suggests what we already know, that stocks don't spurt upwards most of the time.

A final note: One of the most attractive features of convertibles, a feature pointed out by consultants to pension funds, is that a convertible portfolio will typically be less volatile than a portfolio of common stocks. This means that convertibles offer investors a more favorable risk/reward ratio than do common stocks.

CHAPTER

4

How Value Line Evaluates And Ranks Common Stocks And Convertibles

COMMON STOCKS

The Value Line proprietary Ranking System for Timeliness™ and Performance for common stocks is designed to select equities that are likely to perform best over the coming six to 12 months. The Ranking System favors stocks whose relative earnings are higher than their relative prices. These are the issues likely to perform best in the market. The Timeliness rank tracks the approximately 1,700 actively-traded stocks found in *The Value Line Investment Survey*® and the Performance rank is used in *The Value Line Investment Survey — Small & Mid-Cap* to track its universe of 1,800 small- and mid-cap stocks. Instead of looking at just the present quarter, however, a 10-year history of earnings and prices is systematically analyzed. Each company's stock is examined relative to the other stocks tracked in the Value Line universe.

Among other factors, the Value Line Ranking System takes into account "price momentum" and earnings "surprises." In addition, when a company reports earnings that are either substantially better or substantially worse than the analyst estimated, investors are "surprised" and the price of the stock may respond accordingly.

Each universe (*Investment Survey* and *Small & Mid-Cap Survey*) of the approximately 3,500 total stocks that Value Line analyzes and evaluates are ranked from best to worst. The 100 best in each universe are ranked 1 (these stocks are the most likely to outperform the others during the coming six to 12 months); the rest are ranked in the following order:

Rank	Expected Performance
1	Highest
2	Above Average
3	Average
4	Below Average
5	Lowest

It is important to bear in mind that the Value Line Ranking System for Timeliness and Performance predicts relative performance, not absolute performance. In a rising market, stocks ranked 1 are expected to perform better than stocks ranked 2, 3, 4, and 5, and stocks ranked 2 would be expected to outperform stocks ranked 3 and lower, etc. But, again, rankings are "relative": in a falling market, even top-ranked stocks may fall. If they do, however, price declines are expected to be less than the declines of lower-ranked issues.

CONVERTIBLES

The ranks assigned to common stocks predict price performance only. The ranks assigned to convertibles predict total return, including both price change and interest or dividend income. Unlike the ranks assigned to common stocks, ranks assigned to convertibles are "risk adjusted."

Investment risk is measured in terms of price volatility. The more up and down movement there is in a price, the greater the risk that the value may not be there when you need it. A convenient way to visualize risk is in terms of the volatility in the average stock. If we say the risk (or volatility) in the average stock in the universe of more than 3,500 stocks in *The Value Line Investment Survey* and *The Value Line Investment Survey — Small & Mid-Cap* is equal to 100%, it's easy to visualize the risk (or volatility) in other issues. For example, an issue with a "relative volatility" of 200% would be twice as risky as the average stock, while one with a relative volatility of 50% would be half as risky. In *The Value Line Convertibles Survey*, you will find the relative volatility of every convertible, and of their underlying stocks, as well. This makes it easy to select only those issues whose risk is in a range acceptable to you.

As mentioned above, convertible ranks are adjusted for risk. That is, ranks for these issues take into account the total return expected from the price appreciation and income of the issue versus its risk. The expected price appreciation of the issue depends, of course, partly on the movement of the underlying stock. But the interest or dividend the issue pays, plus the extent to which the issue's price will participate in a rise or fall in the underlying stock, are more important factors in the issue's performance.

Once we estimate the total return that the convertible is likely to provide, we are ready to rank it, and we do this by comparing the estimated return with the risk of the issue. This gives us a "reward/risk" ratio. Ranks are assigned on the basis of this ratio.

For example, if an issue was required to have a reward/risk ratio of .20 in order to be ranked 1, then an issue with a relative volatility of 100% would be ranked 1 if it offered an expected return of at least 20%. Similarly, another issue with half the risk (i.e., a relative volatility of 50%) would also be ranked 1 if it was expected to return at least 10% over the coming year. And an issue with a relative volatility of 200% would need an expected return of at least 40% to be ranked 1.

The number of convertibles of a given rank is not fixed. When a large number of convertibles are found to be undervalued, the number that are top ranked will be greater; conversely, when the convertible market becomes overheated, the number of top recommendations will shrink.

CHAPTER

5

How To Manage Your Convertibles Portfolio From The Especially Recommended List

The object of managing any investment portfolio is to earn maximum returns at an acceptable level of risk. *The Value Line Convertibles Survey* provides the two tools you need to do that. The rank enables you to select those issues that offer maximum returns consistent with their risk. In addition, the relative volatility (risk) of each issue is shown to enable you to select the issues that are at the desired level of risk. To use Value Line recommendations to your best advantage, it is wise to diversify your portfolio, holding a minimum of eight issues in different industries, each having roughly the same dollar value.

Where to find the convertibles Value Line recommends

A list of Especially Recommended Issues is posted on our Website weekly and can be viewed by choosing the "Commentary" tab below the main menu. In addition, there is a weekly updated list of all convertibles ranked 1 (Highest) for year-ahead performance from which the Especially Recommended Issues are selected.

How to manage a portfolio directly from the Especially Recommended list

Although we suggest that you become familiar with all of the information contained in the service, you can manage your portfolio solely from the Especially Recommended list. All issues on this list are ranked 1 (Highest) for year-ahead performance and are recommended for purchase. Issues on the list are set out in groups according to profit potential and risk:

- Above-Average Profit Potential — Above-Average Volatility
- Moderate Profit Potential — Modest Volatility
- Modest Profit Potential — Low Volatility

How to use the Especially Recommended list

Once recommended, an issue remains on the list until sale is recommended. An issue will be removed from this list for one of three reasons:

- If a convertible's price moves out of line with the common's, its rank will drop to 2 and it will be moved to the "HOLD" table. If the price later comes back into line, its rank will rise to 1 again and it will once more be recommended for purchase.
- The issue has moved into a price range where there is a reasonable chance that it may be called. Though it is still ranked 1 (Highest) for expected year-ahead performance, under the circumstances, we recommend owners continue to hold the issue, but new purchases are not recommended.

- The fundamentals have deteriorated and a SALE is recommended.

The criteria for issues designated as Especially Recommended.

Issues on the Especially Recommended list are selected from the complete list of all 1-ranked issues. When an issue is placed on our Especially Recommended list, it has a reasonably large float (that is, it should be relatively easy to trade), it is favorably leveraged and, except in the case of zero-coupon convertibles, offers a yield advantage over its underlying stock. Excluded from the Especially Recommended list are the highly speculative issues in our three lowest investment grades (J, K, and L).

CHAPTER

6

Selecting Convertibles for Different Market and Interest Rate Environments

How to select convertibles for different market and interest-rate environments.

The guidelines below are intended to help you select the best convertibles to meet your specific investment objectives. Before purchasing any convertible, however, you will want to be sure that it meets some basic requirements. Under what conditions is it callable, for example? Is it fairly priced relative to the underlying stock? Is the credit-worthiness of the issue acceptable? Does it provide sufficient income? What are the prospects for the underlying stock?

If the convertible meets your requirements in these areas, you will then want to determine whether the issue is sensitive to, or insulated from, movements in the underlying stock and changes in interest rates. Here's how:

Convertibles incorporate characteristics of both equity and debt instruments. A convertible trading close to its conversion value will follow in step with the stock's price changes, particularly on the upside. A convertible trading close to its investment value and well above its conversion value will act like a straight bond, rising and falling in relationship to bonds or preferred stocks of similar investment grade, term and interest rates. As such, convertibles can be selected that are geared to perform best in any particular environment.

As a manager of a convertibles portfolio, you have still further latitude in positioning your holdings. In terms of risk, convertibles can be selected with relative volatilities from 20% (one-fifth as risky as the average stock) to 200% (twice as risky). Convertibles can also be found in all quality levels with underlying stocks ranging from blue chip to over-the-counter issues.

While timing market conditions is a difficult task even for investment professionals, there are times when the signposts seem clear. The guidelines offered here will enable you to achieve the degree of sensitivity to the bond and equity markets with which you are comfortable, given your risk requirements and view of market prospects.

Selecting the right convertible.

Just what characteristics should one look for in a convertible to position it for particular market and interest-rate environments? Factors such as coupon, time to maturity, quality and yield to maturity affect the performance of all interest-sensitive instruments, and can be used to further fine tune a portfolio of convertibles positioned at the income end of the spectrum. These are discussed below. But to get to that end of the spectrum, we must first consider the magnitude of the issue's premiums over conversion and investment values.

	Premium Over		Premium Over		Premium Over	
	CV	IV	CV	IV	CV	IV
Rising Equity	Low	Low	Low	Moderate	Low	High
Flat Equity	Moderate	Low	Moderate	Moderate	Moderate	High
Falling Equity	High	Low	High	Low	High (Consider Hedges)	High (Consider Hedges)

In the figure above, we have set out a table which shows the premiums over conversion and investment values to look for that will position a portfolio for a specific outlook for the bond and equity markets. Notice that premium levels are classified as low, moderate, and high. A low premium ranges from 0%-30%, moderate from 30%-50% and high from 50% and above.

Rising Equity Market/Falling Interest Rates: This is a win-win scenario for convertibles. Both markets are moving in a direction which will boost an issue's price. In this type of market, look for issues with low premiums over conversion value or investment value, or both.

Rising Equity Market/Flat Interest Rates: With interest rates expected to remain flat, less exposure to interest rate moves is acceptable so a moderate premium over investment value should be considered. The premium over conversion value should remain low to take advantage of rising equity values.

Rising Equity Market/Rising Interest Rates: Though it is unusual for the market to make a sustained rise when interest rates are increasing, if an uptick is expected in the market, a low premium over conversion value would be desired. Now, of course, sensitivity to the bond market should be shunned, which means a high premium over investment value. In such an environment, it would be prudent to seek added protection for the portfolio in the form of some sort of hedge, such as selling common short against the long convertible, or selling covered call options against the portfolio.

Flat Equity Market/Falling Interest Rates: The outlook for declining interest rates again justifies a low premium over investment value. A low premium over conversion value is no longer a prime requirement.

Flat Equity Market/Flat Interest Rates: With both markets expected to be flat, moderate premiums over both conversion and investment values would be in order. In this type of market, investors would look for convertibles that offer attractive yields consistent with the investment grades with which they are comfortable.

Flat Equity Market/Rising Interest Rates: An outlook for a flat equity market warrants a moderate premium over conversion value, offering some exposure to an upturn in the market. But again, rising interest rates don't usually augur well for a rising - or even a flat - market. In any event, with interest rates expected to rise, emphasis would be placed on issues with high premiums over investment value.

Falling Equity Market/Falling Interest Rates: This type of market is also rare. Lower interest rates usually spark a rally in stock prices. Given this outlook, however, you would choose low premiums over investment values and high premiums over conversion values.

Falling Equity Market/Flat Interest Rates: In this case, emphasis would be on selecting issues with little sensitivity to the equity side of the market and low premiums over investment values to provide downside protection in case of a drop in the prices of the underlying stocks.

Falling Equity Market/Rising Interest Rates: This is the worst possible scenario for convertibles. It calls for high premiums over conversion and investment values. It would be an ideal time to consider hedging strategies to cushion your position. Convertibles should also be selected based on company strength, targeting industries expected to weather the downturn well. Yields that can help withstand the downturn are also desirable.

Fine tuning selections for expected changes in interest rates: Generally, three features of a bond determine how it will respond to changes in interest rates; the time to maturity, coupon rate, and quality. Thus, if you are choosing between issues that are identical in all respects other than these three features, you can position your portfolio to your interest rate outlook as follows:

For **Falling Interest Rates,** increase Sensitivity by choosing issues with:

- More time
- Lower coupon
- Lower quality

For **Rising Interest Rates,** reduce Sensitivity by choosing issues with:

- Less time to maturity
- Higher coupon
- Higher quality

It is important to remember, however, that convertibles have varying sensitivity to interest rates. Convertibles trading on their conversion values and well above their investment values are relatively impervious to changes in interest rates. At the other end of the spectrum, issues trading on their investment values and well above their conversion values are highly sensitive to changes in interest rates. Thus, if you wished to align a portfolio to benefit from a drop in interest rates, it would be of no avail to switch into an issue with a lower coupon, more time to maturity or lower quality if that issue was trading on its conversion value, and was essentially a stock equivalent.

The key figure in determining interest rate sensitivity is the ratio of conversion value to estimated investment value. For example, if the conversion value is 45 and the investment value is 60, the ratio is 0.75 (45/60). Generally, issues with a ratio well below 1 have a high sensitivity to changes in interest rates, while those with ratios well above 2 have virtually no sensitivity. The following table provides an estimate of a convertible's interest-rate sensitivity:

Ratio of conversion value to investment value	CHANGE IN INVESTMENT VALUE			
	+50%	+25%	–25%	–50%
	Estimated change in convertible's price*			
.25	+49%	+24%	–24%	–48%
.50	+45	+22	–22	–41
.75	+40	+19	–18	–31
1.00	+33	+16	–13	–20
1.25	+27	+12	–9	–10
1.50	+20	+ 9	–4	–4
1.75	+14	+ 5	–1	–1
2.00	+ 8	+ 3	0	0
2.25	+ 4	+ 1	0	0

*Since the ratio doesn't depend on the convertible's price, the table assumes the convertible is fairly priced and its price will not be influenced by the likelihood of redemption or approaching maturity. The table doesn't apply to plus–cash convertibles (Note that the investment value of a particular issue may not vary proportionately with prevailing interest rates due to the likelihood of redemption or the approach of maturity.)

CHAPTER

7

How To Select A Broker, How To Trade Convertibles

Trading convertibles is quite different from trading stocks, listed options or other listed securities. This is because more than 80% of all convertibles are traded over the counter by firms that make markets in the particular security. Thus, though an issue may be listed on an exchange, prices quoted there may be "away" (differ) from the actual market. Indeed, a vast majority of prices shown in *The Value Line Convertibles Survey* are averaged bid/ask spreads from various market makers and are not taken from the exchanges.

Unlike listed issues for which there is an auction market, the bid/asked price quoted for convertibles by various market makers may be different. In the case of a lightly traded issue, one quotation may be several points away from another.

Among the major brokerage houses which actively trade convertibles are Goldman Sachs and Morgan Stanley. A number of smaller brokerages make markets in convertibles, as well. But not all houses trade every issue. Of course, even if a house makes a market in a particular issue, it may not have the best price.

CHOOSING A BROKER

Neither at full-priced brokerage houses nor at discount houses are all account executives schooled in convertibles. If your account executive is awkward dealing in convertibles, it may well pay to find another with experience in this field.

Generally, a firm that makes markets in convertibles is better placed to handle orders than one that doesn't, but there are drawbacks, too, for these firms often put trades through their own convertibles desks exclusively rather than checking among the various market makers for the best price. Thus, a knowledgeable discount broker will often execute a trade as well, or better, than a full-service broker and save you commission or spread.

Trading convertibles: Perhaps the major difficulty in trading convertibles is one of liquidity, which is a measure of the ease of trading. *The Value Line Convertibles Survey* grades liquidity on a scale of 1 to 6, from best to worst. Issues graded 3 or better will usually trade easily in quantities of $500,000 or more, while issues graded 6 will be hard to trade at any price. But the market — even for liquid issues — may dry up at times, so trading convertibles successfully requires two things:

- An understanding of the price relationship between the convertible and its underlying stock; and
- Patience.

Illiquid issues often trade at price spreads of 4 to 5 points or more, so even if you can buy an illiquid issue at a fair price, you may not be able to sell it at a fair price later. When it comes to more liquid issues, unless you have an urgent need to sell, if the price of the issue is out of line with the underlying stock, sit tight until it moves back in line. (Naturally, there's rarely, if ever, a reason to buy an overpriced issue.)

Finally, since convertibles move with the price of the underlying stocks, it is best to confirm trades with the broker as quickly as possible. But if that's not possible, place Day Orders only, never Good-Till-Canceled orders.

When a convertible is called: Once a convertible is called, the holder usually has about 30 days in which to convert—if he or she chooses to do so. During that period, he or she may also sell the convertible. If the holder does neither, the issue will be redeemed by the company at the stated price.

Once called, the price of the convertible will move to the call price or conversion value, whichever is higher. Naturally, if the conversion value is higher, it pays to convert. But if you convert, don't convert before an interest payment if you can avoid it, or you will forfeit the accrued interest.

In some cases, you have no choice but to convert before an interest payment date or you'll be left accepting a call price which is lower than the conversion value. You can still sell the convertible, but the price will only reflect conversion value. Typically, it will be one of the market makers who will bid for the issue at this time, bidding conversion value less a small amount to compensate for any loss before the sale of the security. Before selling the issue, however, be certain that the issuer will not pay the accrued interest, because honest confusion does occur, even among the market makers.

How to close out a position in a convertible trading on its conversion value at a premium over the market: Issues may trade at (or below) conversion value when called, when a call is expected, or when the conversion value is substantially above the investment value and the income yield has dropped below that of the underlying stock. Instead of selling such an issue, there are several other ways to close out your position that may be more advantageous. You can, for example, sell short the underlying common, convert the issue and deliver the common to cover your short position. (A short sale is the sale of stock you do not own; to do this, the broker must borrow the stock from an owner.) In this way, you save any special charges a market maker might make. Check carefully, however, for it may be difficult to borrow the stock and, the commissions may more than offset the savings.

But if the issue is optionable, you can almost always sell it at a premium over the market by selling calls against it, for calls almost always sell at a premium.

It works this way: Assume you held 10 bonds that have been called at $1,040. Each bond is convertible into 50 shares of stock, the stock is selling for $25 a share, so the conversion value of the bonds is $1,250. Naturally, you plan to convert or sell the bonds rather than let them be called away. Before you do so, however, you check the listed options on the stock and find that a call expiring in one month, exercisable at $20, is selling for $5.50 a share ($0.50 more than its tangible value).

(The tangible value of an option is the amount the option would be worth if it were exercised and the stock were sold at its current price. Thus, it is equal to the price of the stock less the exercise price of the option. In this example, that's $25-$20, or $5.)

In this scenario, commissions would be slightly higher if you sold the calls rather than sold the bonds, but it would still leave you with a net advantage of about $415. Bear in mind, however, that the market maker will usually pay you a price based on the price at which he or she can sell the underlying common and, in doing so, he or she might well depress the stock, which means that if you sold to him or her you might wind up with less than $12,250 for the bonds.

On the other hand, if you sold calls to close out your position, you would be assured of receiving the amount you expected only if the stock didn't fall below the exercise price at expiration. If it did, you could wind up with less. In this example, by selling a call exercisable at 20 for $5.50, you realize $25.50 a share for your convertible as long as the stock is $20 when the call expires, and you still come out with $25 a share if the stock drops to $19.50. If it were to fall further, you'd do less well (though you also pocket any dividends paid on the stock from the time you convert until the issue is called away).

Notice that in this example that by selling the calls, you come out ahead even if the stock drops 20% and you do as well as you would if you sold the convertible even if the stock drops 22%. If you held just a couple of bonds, it might not be worth the trouble, but if you had a large quantity, the difference could be substantial.

Sell bonds:	Sell 10 bonds @ $1,225 ($1,250 – 1/4 point)	= $12,250
Sell calls:	10 bonds convert into 500 shares; as each call is for 100 shares, you'd sell five calls @ $5.50 a share or $550 a call	= $2,750
	When the holder exercises the calls, you receive $20 a share x 500 shares	= $10,000
	Total	$12,750
	Advantage	$500

PRICING YOUR PORTFOLIO

Most convertible preferred stocks are listed on an exchange and so their price movement is relatively easy to follow. Most convertible bonds, however, are traded by market makers, so their prices won't be listed publicly. One way to price these issues is to get quotations from your broker, or use price quotations listed in *The Value Line Convertibles Survey*.

Remember when valuing bonds to add the interest accrued from the last interest payment date (except if the bond trades flat, without accrued interest). To calculate accrued interest, multiply the coupon in dollars by the number of days since the last interest payment and divide by 360. For example, the accrued interest 60 days after the last interest payment on a 5.0% bond would be $50x60/360 = $8.33. Many broker's websites include tools for calculating accrued interest.

Value Line Publishing LLC
551 Fifth Avenue
New York, NY 10176-0001
vlcr@valueline.com

Value Line®