

SmartChoice Rollover™

Move your old 401(k) ahead by investing in a well-diversified, professionally-managed retirement portfolio.

Select your age to find a fund:

▲ 43
■ 44
▼ 45
▲ 46
▼

T. Rowe Price
INVEST WITH CONFIDENCE
Call (800)416-2930



Money & Investing

Convertible Bond Bargains

Emily Lambert 02.16.09, 12:00 AM ET

Charles (Chip) Carlson is a bargain hunter. The morning after Christmas the manager of the Greenspring Fund headed to the mall to stock up on discounted pants and shirts. At his 11-person firm in Lutherville, Md., near Baltimore, a vice president waters the plants. When the fund splurges for Friday lunches, it usually orders out from a deli that offers 20% off.

"We only buy what we need," says Carlson.

Such thinking has enabled Carlson and his investing partner, Michael Fusting, both 48, to shine. Their fund has returned an annual average of 7.7% during the last 15 years, versus the S&P 500's 6.5%. All of that excess return and then some was earned last year, when Greenspring was down 12% to the overall market's 37% shellacking.

"It should be better known," says analyst John Coumarios of Morningstar, which accords Greenspring five stars.

Carlson, the ever enthusiastic good cop, and Fusting, the skeptical bad cop, are parking 23% of Greenspring's \$315 million in so-called busted convertible bonds. (Another 26% is in junk bonds, 38% in mostly obscure small and midcap stocks and 13% in cash.) Carlson and Fusting don't advertise and instead rely on word-of-mouth and fee-based advisers to recommend their no-load fund. At 1.03% a year in fees, it isn't particularly cheap, but you'd have to do a lot of work to manage a portfolio heavy in convertible securities on your own.

Convertibles are bonds or preferred shares that can convert into common stock at a predefined price. Smallish firms favor them as a way to issue debt while paying out lower interest than they would need to offer to lure investors to straight bonds. The downside: They have to share the gains if the company does well. If the issuer's stock price rises to the conversion threshold, holders of the convertibles will sooner or later swap the bonds for stock and dilute the existing shareholders. (The bond investors can take their time converting if there's no deadline and if the bond is paying a nice yield in the meantime.)

Newly issued convertibles trade like a blend of stocks and bonds. Over time a convertible may veer off to one side of the bond-equity spectrum. If the underlying stock does extremely well, the convert's fixed-income attributes diminish in importance and the convert becomes just another way to own the stock. Example: the Chattem bonds issued in 2006, trading at \$1,110 per \$1,000 of par value and convertible at any time into 17 shares of Chattem, currently worth \$1,088. This convertible bond moves up and down almost in lockstep with the common stock.

If the underlying stock does badly, on the other hand, the conversion feature becomes irrelevant and the bonds trade on their fixed-income value: the right to collect \$1,000 at maturity and a semiannual coupon payment in the meantime. The disappointed holders of these securities use the adjective "busted" even though the issuer may be in fine financial shape. Example: Sepracor zero coupon bonds of 2024 pay no annual interest and are priced at \$937.50. Sepracor stock has sunk like a stone since the bond was floated in 2004.

The Sepracor bonds can be converted into 15 shares of stock, a laughable idea, given that this many shares are currently worth \$195. But even if you consider the embedded call option worthless, you might find the bond a safe and attractive bet. Sepracor, which makes the prescription sleep aid Lunesta, is sitting on \$787 million in cash and investments, versus debts of \$617 million. Since the bonds can be put back to the issuer at par in October, their effective maturity is eight months. Greenspring owns \$14 million (par value) of this bond.

[Special Offer: Free Trial Issue of Forbes](#)

A big part of the reason many converts are on sale is that convertible arbitrage hedge funds, formerly responsible for most of the market's trading activity, have been forced to dump converts at fire-sale prices (see "[Seeking Converts](#)"). What's more, once a

bond issuer's stock price falls well below its conversion value many investors lose interest.

According to Fusting, that has already happened. "The downside is basically wrung out," he says.

When on the prowl for bargains, Fusting and Carlson dissect converts themselves rather than rely on rating agencies. The raters, they say, too often ignore--or even mislabel--safe investments. Example: They often label all senior secured debt from an issuer identically, regardless of when it matures.

Greenspring focuses on bonds maturing quickly so issuers don't have a lot of time to sour. The bonds in its portfolio mature in 1.4 years on average.

In September Greenspring bought busted converts, issued by Digital River, for 98 cents on the dollar. That price gave the bonds an 8% yield until Greenspring exercised a put option in December. Meanwhile, Digital River was a safe credit, sitting on \$600 million in cash and only one debt--the \$195 million convertible bond issue.

With busted converts, surprises can be good news. Greenspring was holding some of Mentor's busted converts with a conversion price of \$29 per share when Johnson & Johnson made a \$31 buyout offer in December. The stock price shot from \$16 to \$31. The bonds Greenspring bought for 97 cents on the dollar rose 5% above par. That created an annualized return somewhat higher than the 15% the Greenspring managers had expected.

A Broken Model

Busted convertible securities are not an easy sell with investors these days. But Greenspring has discovered, for those willing to do their homework, some pretty safe issues on the market that offer attractive yields.

COMPANY	COUPON	END DATE*	ANNUALIZED YIELD
Agere Systems	6.50%	12/15/09**	7.0%
Allied Waste Industries	4.25	4/15/11	7.5
Digital River	1.25	1/1/09	8.0
Mentor Corp	2.75	1/1/09	15.0
Sepracor	0.00	10/15/09	9.5

Agere Systems, Allied Waste Industries and Mentor Corp. have been or are in the process of being acquired. *Date of put option unless noted. **Maturity date. Sources: Greenspring Fund; bond issuers.