A commonly used but often misunderstood tool

An opportunity to earn current income without giving up the prospect of capital growth

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By Kim Inglis

According to Deloitte, the Canadian marketplace is home to over $14 billion in publicly traded convertible debentures. Deloitte notes their appeal is growing because convertible debentures allow issuers to take advantage of lower cash costs and high yield potential, and they also give investors the opportunity to earn current income without giving up the prospect of capital growth.

Typically described as hybrid securities, they offer a blend between fixed income and equity. Convertible debentures are corporate bonds where the investor has the option to convert into a fixed number of the issuer's common shares at some specified future date. The opportunity to convert into the underlying stock has appeal because of the potential to profit from a company's success as reflected in a higher share value.

Similar to fixed income investments, convertible debentures offer regular interest income via coupon payments, typically paid semi-annually or annually; and offer protection of this income because the fixed coupons must be paid out before any dividend distribution.

Convertible debentures also offer a level of principal protection because the face value is redeemed by the issuer in full at maturity. In the event of liquidation, holders of convertible debentures rank above all equity shareholders.

Diversification potential exists because convertible debenture performance is not directly correlated to either equity or bonds and, since most are traded on public exchanges, transparency and efficiency in pricing is inherent.

On the downside, convertible debentures also carry risk, the most notable being the credit risk on the issuer. Generally speaking, the Canadian convertible debenture market is sub-investment grade and very few are rated. As a result, it is up to the investor to determine the issuer's risk of default in the event they aren't able to repay their debt obligations.

Because convertible debentures resemble equities, they generally gain or lose value analogous to movements in the underlying stock. If the price of the underlying stock rises, so too does the convertible debenture but, if the price of the underlying stock falls, the convertible debenture will too. However, their downside tends to be limited, as the debenture will start to take on its bond characteristics if the price falls below a certain level.

Convertible debentures are also subject to interest rate risk. They are inversely correlated to the level of interest rates. As interest rates rise, convertible debenture prices fall and vice versa. Given our current low interest rates, this is an important consideration.

Call risk is another important consideration. When a convertible debenture is callable, the issuer has the right to redeem before maturity. That can result in reinvestment risk because the investor is forced to reinvest their principal sooner than expected at a potentially lower rate.

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Finally, convertible debentures tend to be less liquid than other securities. They are fairly thinly traded, so the spread between their bid and ask prices can be wide. An investor needing to sell in a hurry could be risking a loss simply because of the pricing spread.

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