

# Investment Perspectives

Timely Insights For Today's Portfolios

December 1999

## Convertible Securities — The Best of Both Worlds From One Investment

By Andrew S. Chow, CFA

If ever there were investment alternatives that sought to optimize the risk and return potential of the stock market, they are convertible securities. Convertibles can act as calming influences in times of uncertainty, especially for investors who are nervous about the volatility of the market.

Such investors could benefit from an understanding of how these securities work, the unique benefits and risks of including them in a portfolio, and how to get the most out of a convertible securities fund.

### What are convertible securities?

Convertible securities are “hybrid” securities that have the potential to provide the best attributes of stocks and bonds in a single investment. There are generally two types of convertibles: convertible preferred stock and convertible bonds. The most common type is the convertible bond, issued in \$1,000 denominations with a fixed interest rate, or coupon, and a maturity date. However, unlike the owner of a traditional bond, the owner of a convertible has the option — but not the obligation — to convert the holding to a specified number of shares of common stock of the issuing firm at any time.

### Helping investors manage market risk

Essentially, convertible bondholders are creditors of a company with the option of becoming equity participants. They can convert to stock when it is advantageous to do so, or retain the bond when it is not advantageous to convert. In other words, convertible bondholders could receive the **upside potential of stock appreciation with the downside protection of a bond** — the best of both worlds from one investment.

Keep in mind, convertibles are often fixed-income securities of lower-grade investment quality than other investment alternatives. As a result, they are subject to greater risk of loss than are higher-rated fixed-income securities.

*Convertible holders*

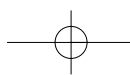
*could receive the*

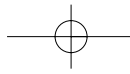
*upside potential*

*of a stock with the*

*downside protection*

*of a bond.*





### Enhancing return potential with reduced risk

The attractive risk/return characteristics of convertible securities relative to stocks and bonds are shown in the table below.

As this chart illustrates, the S&P 500 Index outperformed the Merrill Lynch Domestic Master Index by an average of 7.47%. The Merrill Lynch Broad Convertible Index captured 68.7% of the return while only incurring 45.5% of the volatility (as measured by the S&P 500).

**Risk/Return**  
1/1/88 – 9/30/99

	Average Annual Return	
Merrill Lynch® Broad Convertible Index	13.68%	8.21%
S&P 500® Index	16.02%	13.36%
Merrill Lynch® Domestic Master Index	8.55%	3.91%

Past performance is no guarantee of future results. Indices are used for comparative purposes only and are not intended to represent the performance of any fund. The Merrill Lynch Broad Convertible Index is considered to be representative of the convertible securities market in general. The S&P 500 Index is considered to be representative of the stock market in general. The Merrill Lynch Domestic Master Index is considered to be representative of the domestic fixed income market in general. An investor cannot invest directly in an index. Standard deviation is a measurement of how far annual returns have varied from the average.

## How convertibles work

In general, a convertible bond tends to rise in value when the price of the underlying stock rises, but not at the same pace. Conversely, when the underlying stock price declines, the value of a convertible bond tends to follow, but to a lesser degree. In either case, the convertible bond will return its full (par) value at maturity, as long as the issuer does not default.

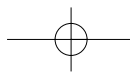
While the chart below does not represent the performance of a specific investment, it provides examples of when a convertible bond may be converted. The scenarios reflect the assumption that an investor holds the following hypothetical convertible bond:

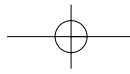
\$1,000 XYZ Co. 4% due 01/02/01  
Convertible into 10 shares of XYZ Co. common stock at \$90 per share

Scenario	Market conditions	Conversion value	Incentive to convert
1	<ul style="list-style-type: none"> <li>XYZ Co. common stock falls to \$80 per share</li> <li>XYZ Co. convertible bond approaches maturity and is trading at \$950</li> </ul>	10 shares X \$80 = <b>\$800</b>	<b>None</b> — the conversion value is lower than the bond; at maturity, the convertible has no downside risk and pays the investor the face value of the bond (\$1,000)
2	<ul style="list-style-type: none"> <li>XYZ Co. common stock rises to \$110 per share</li> <li>XYZ Co. convertible bond approaches maturity and is trading at \$1050</li> </ul>	10 shares X \$110 = <b>\$1,100</b>	<b>Likely</b> — while the convertible bond has no downside risk at maturity, a rising stock price offers some incentive to convert

Scenario 1 above illustrates that there is no incentive to convert, as the conversion value of the underlying stock is less than that of the bond. In Scenario 2, where the conversion value of the stock exceeds that of the bond, the holder is more likely to convert.

While the decision to convert is dependent upon the prices of the stock and the bond at a given point in time, many times, convertible bonds are never converted. However, before convertible bondholders make their decision, they must consider a number of additional factors, including the size of the difference in values, the length of time to maturity of the bond, interest rate trends, and the future growth prospects of the company and its stock.





## What types of investors might consider convertibles?

Convertible securities may be appropriate for almost any type of investor. First-time or cautious investors who want to “sample” equity investing, without all the risk of investing completely in the equity markets, may find these vehicles to be excellent alternatives.

For equity investors who are concerned about the current high levels of equity markets, convertibles may help them reduce their overall risk exposure while maintaining the opportunity to participate in any rise in the equity markets. Since they are issued primarily by small and mid-size companies, convertibles may provide an effective way to participate in the potential profitability of these markets while maintaining a moderate risk profile.

*Convertible securities funds are a relatively conservative approach for long-term investors seeking strong total return.*

## Professional management: The best way to access convertibles

One way to access the benefits of convertibles is to invest in a convertible securities mutual fund. As with any other mutual fund, an investor quickly gains a broad level of diversification and has the opportunity to access the resources and expertise of investment professionals who are dedicated to, and specialize in, investing in these types of securities.

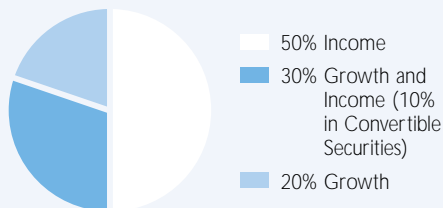
Professional money managers seek to add value to the investment process by effectively utilizing their own extensive research resources to find the best investment alternatives. Because they are constantly in touch with the market, professional managers generally can buy and sell convertibles more easily and with more confidence than individual investors. In addition, fund managers continually monitor economic and market activity to determine the impact that changes in these areas may have on their portfolios.

### How much is enough?

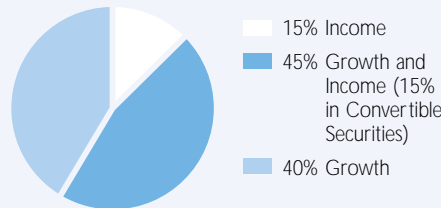
How much of a portfolio should be invested in convertibles depends on the individual investor’s goals, tolerance for risk and time horizon, as well as the amount a portfolio is currently weighted toward growth and income investments.

In general, investors may consider allocating approximately one-third of their growth and income assets toward convertible securities.

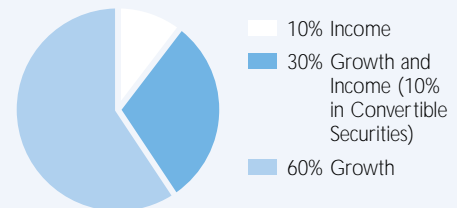
Conservative Portfolio



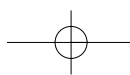
Moderate Portfolio

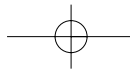


Aggressive Portfolio



Asset allocations for each portfolio are for illustrative purposes only. Based on your personal situation, your investment professional can help you determine the best way to allocate your assets.





## Not all convertible securities funds are created equal

As with any specialty fund, a convertible securities fund generally will have the majority of its assets invested in its specialty — in this case, convertible securities. The percentage of assets invested in the other asset classes (stocks, bonds and cash) can have an impact on the fund's level of volatility, or risk profile.

Because convertible securities themselves tend to have less risk than stocks, a fund more heavily weighted in convertibles than in stocks will generally have a lower risk profile. Two indications of a fund's risk profile are its beta and its standard deviation.

- Beta measures the magnitude of share price fluctuations in a fund in relation to the market as a whole. A beta greater than 1 indicates that the fund will be more volatile than the overall market, typically measured by the S&P 500 Index, while a beta less than 1 means that it will be less volatile.
- Standard deviation measures the degree to which a fund's return varies from the average of all similar funds. A high standard deviation means the fund's returns will vary significantly from its peer group, while a low standard deviation means it will generally perform in line with its peer group.

When selecting a convertible securities fund, you will want to take into consideration these two measurements, as well as the percentage of the portfolio allocated to non-convertible securities and a fund's total return.

## Keys to selecting the right convertible securities fund

While the universe of convertible securities funds is relatively small (currently 56 funds), prospective investors should consider many of the same criteria that they would when selecting any other mutual fund investment.

### Management ability

Because investing in convertible securities is a specialty, an investor should pay particular attention to the success of the fund manager. An investor should feel comfortable that the fund manager has demonstrated a level of expertise in this field.

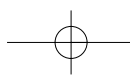
### A clearly defined and highly disciplined investment approach

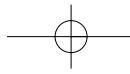
One of the keys to investment success is a disciplined, well-defined process for analyzing, buying and selling securities. An investor must understand and be comfortable with the portfolio manager's process and investment philosophy.

## Getting into convertibles

While convertibles represent a relatively conservative way to pursue total return, investing directly in convertible securities can be difficult and seem daunting to many investors. The following are examples of the considerations they may face:

- Are convertible securities readily available?
- Where do I find information on the various convertible securities on the market?
- How do I track the performance and quality of the individual securities?
- When is the best time to convert the holding to its underlying stock?
- How can I achieve adequate diversification across issuers and industries?





## Extensive resources

With research being the primary driver of fund performance, the quality and depth of a company's research department, as well as the degree to which a convertible securities fund manager leverages those resources, is a reasonable factor in evaluating potential funds. Research is particularly important in convertibles because they often are issued by companies with lower credit ratings than other fixed-income securities.

Some funds put their faith in the talent of an experienced manager and a small team of analysts. Others leverage their company's entire research organization, including analysts from their fixed-income and equity areas. This approach takes advantage of equity analysts who specialize in specific industries, and fixed-income analysts who can examine companies from financial angles that typically are overlooked by equity analysts.

Because convertibles aim to provide the downside protection of a debt security while providing the option to access the growth potential of an equity security, leveraging equity and fixed-income analysis becomes that much more important. Without a complete picture of a company, including qualitative and quantitative factors, it is difficult for a fund manager to make well-informed decisions.

*Without a complete picture of a company, including qualitative and quantitative factors, it is difficult for a fund manager to make well-informed decisions.*

## Performance

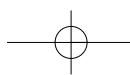
No mutual fund discussion would be complete without a caveat that past performance of any fund is not indicative of future results. That being said, it is important for prospective investors in any type of fund to examine a fund's historical performance versus its peer group and any relevant benchmarks — such as the Merrill Lynch Broad Convertible Index or the First Boston Convertible Bond Index. The following table shows how convertible securities funds, as a group, have performed against their benchmarks over the time periods noted.

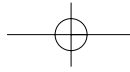
**Convertible funds versus the convertibles market\***  
(Average annual returns for periods ending 9/30/99)

	3 Year	5 Year	10 Year
Merrill Lynch Broad Convertible Index	14.32%	15.01%	12.85%
First Boston Convertible Bond Index	12.90%	13.66%	11.79%
Average Convertible Securities Fund	12.01%	12.81%	12.13%

\*Performance for the average convertible securities fund represents an average of 56 convertible securities funds and was provided by Morningstar® Principia® Pro, 9/30/99. The Merrill Lynch Broad Convertible Index and the First Boston Convertible Bond Index are considered to be representative of the convertible securities market in general. Past performance is no guarantee of future results. Indices are used for comparative purposes only and are not intended to represent the performance of any fund. An investor cannot invest directly in an index.

As a group, convertible securities funds have performed competitively against their benchmarks over the long term.





---

## Differentiating convertible funds from balanced funds

Some people may assume balanced funds can provide the same benefits as a convertible fund. Similar to convertible funds, balanced funds seek total return through a combination of income and appreciation. However, there are key differences.

A balanced fund typically comprises two “sub-portfolios” — one of stocks and the other of bonds. This requires the money manager to invest in a wide variety of securities within each sub-portfolio, which demands much more time for analysis and monitoring of different types of securities. Additionally, balanced fund managers must make an active effort to adjust a portfolio’s allocations to stocks or bonds as market conditions change.

A convertible securities fund provides access to the performance characteristics of bonds and stocks within a single investment vehicle. It also enables the fund’s management team to focus its efforts on a fewer number of securities in an effort to maximize return potential for investors. Historically, convertible funds have outperformed balanced funds throughout market cycles.

*A convertible securities fund seeks to access the performance characteristics of bonds AND stocks within a single investment vehicle.*

## Convertible securities funds — the best of both worlds from one investment

Designed to offer the upside potential of stocks and the downside protection of bonds, a convertible securities fund can be an attractive option for investors seeking an additional level of diversification for their portfolios.

By working with their investment professionals, investors can clarify their investment objectives and risk tolerances, and determine the role that convertible securities funds might play in their investment portfolios.

---

Andrew S. Chow, CFA, is a vice president at Conseco Capital Management, Inc. (CCM) and portfolio manager of the Conseco Convertible Securities Fund. Prior to joining CCM in 1991, Chow was manager of quantitative analysis at Washington Square Capital, where he was responsible for mortgage-backed securities, non-dollar bonds and derivatives. He holds a bachelor’s degree from the University of California at Berkeley and a master of business administration from Carnegie Mellon University. Currently, Chow manages more than \$3 billion in assets for institutional investors.

Conseco Fund Group mutual funds are managed by Conseco Capital Management, Inc. (CCM), with more than \$41 billion in assets under management, and are offered through Conseco Equity Sales, Inc. (CES). Both CCM and CES are wholly-owned subsidiaries of Conseco, Inc. (NYSE: CNC), which offers insurance, investment and lending products. For more complete information about Conseco Fund Group mutual funds, including fees, sales charges and expenses, please ask your financial consultant for a free prospectus. Be sure to read the prospectus carefully before investing or sending money.

Published by Conseco Fund Group  
© 1999, Conseco Fund Group

Copying or reproducing this report is not permitted without the express written consent of Conseco Fund Group.

---

