

Convertibles and Rising Interest Rates

In the coming years, the potential exists for rising interest rates in conjunction with an improving economy or rising inflation. That possibility raises questions for convertible securities, hybrids with characteristics of both bonds and stocks.

Bonds tend to lose value in an environment of rising interest rates while equities, in many cases historically, have gone the opposite direction.

Convertible securities¹ have fixed-income qualities and can be affected by rising interest rates, but they also can take on equity qualities because of the option to convert them into a predetermined number of issuer shares. In general, the more a convertible's price is determined by the value of its underlying equities, the greater its tendency not to be influenced by changing interest rates.

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The graph below shows what has happened to stocks, bonds and convertible indexes in the past 20 years when the 10-year Treasury yield rose more than 100 basis points. Convertible returns tended to more closely reflect equity returns than bond returns.

RETURNS IN RISING INTEREST RATE ENVIRONMENTS

	15/10/93- 7/11/94	18/1/96- 12/6/96	5/105/98- 20/1/00	7/11/01- 1/4/02	13/6/03- 14/6/04	1/6/05- 28/6/06	30/12/08- 10/6/09	7/10/10- 8/2/11	26/7/12- 6/9/13
Yield increase (bps)*	287	154	263	125	176	136	189	134	155
BofA Merrill Lynch All U.S. Convertibles Index	-2.28	11.97	68.85	2.29	11.49	9.46	24.68	11.63	25.43
S&P 500 Index	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89	26.91
Barclays Capital U.S. Government Credit Index	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94	-3.62

*10-year Treasury yield. Performance shown is cumulative.
Sources: Morningstar and Bloomberg

¹ Convertible securities are interest-paying securities, similar to corporate bonds, in which investors have the option to turn the bonds into a predetermined number of shares. The hybrid nature of the securities offers investors the principal protection and income characteristics of bonds with the opportunity for higher returns if the issuer's stock price rises. This discussion includes convertible bonds and preferred shares.

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There are certain risks associated with an investment in a convertible bond such as default risk—that the company issuing a convertible security may be unable to repay principal and interest—and interest rate risk—that the convertible may decrease in value if interest rates increase.

Government credits are subject to interest rate risk, if rates increase the value of the security declines. Equity securities are subject to "stock market risk" meaning that stock prices in general (or in particular, the prices of the types of securities in which a fund invests) may decline over short or extended periods of time.

Index Definitions

The **BofA Merrill Lynch All U.S. Convertible Index (VXA0)** is comprised of approximately 700 issues of convertible bonds and preferreds of all qualities. The **S&P 500 Index** is considered generally representative of the U.S. stock market. The **Barclays Capital U.S. Government/Credit Index** includes long-term government and investment-grade corporate debt securities and is generally considered representative of the performance of the broad U.S. bond market. Unlike convertible bonds, U.S. Treasury bills are backed by the full faith and credit of the U.S. government and offer a guarantee as to the timely repayment of principal and interest. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect fees, expenses or sales charges. Investors cannot invest directly in an index.

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