

## **DINSMORE CAPITAL MANAGEMENT CO.**

65 MADISON AVENUE, SUITE 550 · MORRISTOWN, NEW JERSEY 07960-7308 · [www.dinsmorecap.com](http://www.dinsmorecap.com) (973) 631-1177

---

# **A VIEW OF THE CONVERTIBLE SECURITIES MARKET JANUARY 2010**

**Thomas H. Dinsmore, CFA**  
**Portfolio Manager**  
**Dinsmore Capital Management**  
[tdinsmore@dinsmorecap.com](mailto:tdinsmore@dinsmorecap.com)  
[www.dinsmorecap.com](http://www.dinsmorecap.com)

The US convertible securities market had a record setting year for performance in 2009. The Bank of America Merrill Lynch US All Convertibles index (VXA0) was up 49.13%. This is the highest one year return in the index's existence. Convertible security returns were more than double that of the Dow Jones Industrial Average and nearly double that of the S&P 500 index.

At the end of 2009 the total return of the VXA0 was ahead of the total return provided by the S&P 500 index for the one year, three year, five and ten year periods ending on December 31. Additionally, the standard deviation of the VXA0 (a measure of its volatility) was less than that of the S&P 500 for each of those periods. Historically, convertibles have been able to provide returns that were less volatile, but competitive with equities. So it makes sense that they have outperformed over this last decade where the S&P 500 was down. Of course this past performance is no guarantee of future returns, but convertibles have done what was expected of them; they provided downside protection, a significant yield and participated in stock price gains.

Within the convertible marketplace in 2009 we saw that the very best performance came from speculative and distressed issues. Issues such as AIG, Fannie Mae, Ford and others that had collapsed in 2008, as many investors sold out of justifiable fear, came back from near death as the financial world stabilized.

Excellent performance also manifested in the form of new convertible issues that were immediately snapped up by investors. Convertibles that were issued in the second half of 2009 averaged gains of over 130% according to Bank of America Merrill Lynch. Unfortunately, participation was difficult as many of these issues were small and demand outstripped supply. New issues of convertible securities were important indicators of the return to health of the convertible securities market. There were 108 offerings and virtually every one was a success, some spectacularly so.

The convert market capitalization has expanded to \$245 billion (source: Barclays) from well below \$200 billion despite dollar amount of convertible redemptions being greater than issuance. The success of the new issues in 2009 bodes well for future offerings which we expect to see expand this year and outpace redemptions. Convertible sectors that outperformed last year were materials (up 99%) which include metals & mining and the consumer discretionary sector (up 89.8%) which includes autos and auto parts. The convertible issues in these sectors were some of the best performers of 2009 by virtue of how low they had fallen in 2008. Others were newly issued at the bottom of the market last spring.

The drivers of this year's performance of the convertible market were directly attributable to the 2008 collapse in prices of many issues. With credit locked up, many hedge funds that had used leveraged convertible arbitrage strategies faced pressures to raise cash especially after Lehman Brothers collapsed. This resulted in forced selling of convertible securities into very thinly trading markets which resulted in bonds trading at almost any price, often below the 'bond floor' that would have been expected to provide price support. For many years, hedge funds have made up the largest part of the volume of convertible trading. With the strain from losses in 2008, many disappeared or substantially cut back their trading. This did affect the liquidity of the convertible market in 2008 and into early 2009.

The second half of 2009 saw the reemergence of the convertible market. Many of the first buyers were cross over investors who wanted to replace common stock holdings with more senior securities that also offered the potential for growth if the stock market recovered or bond funds that felt that certain issues were only being sold for liquidity reasons. Both equity and fixed income buyers were also encouraged when the fixed income markets stabilized and yield spreads on corporate and high yield bonds improved dramatically. High yield spreads tightened from about 1,800 basis points at the end of 2008 to about 700 basis points in mid-December 2009 according to Bank of America Merrill Lynch.

Hedge funds are returning to convertible arbitrage, but they appear to be less leveraged and more disciplined. Many hedge funds now use convertibles in a broader capital structure discipline and are not limited to the arbitrage strategy. This is likely to help liquidity while not crowding out long only un-hedged convertible managers from the market.

Prospects for 2010 look very good. While it is unlikely that the convertible market will see a repeat of 2009, it is our judgment that it is poised to continue to do well relative to the common stock market. According to Barclays the current convertible market statistics are a \$245 billion size, a current yield of 4.1%, a yield to put or maturity of 5.3%, a 4.5 year average to maturity or put, an average premium of 43% and a delta of 60% which is a measure of equity sensitivity. It is my and the investment team at DCM's opinion that the convertible market still has substantial value.