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Wenning Investments, LLC

Wenning Advice

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Consider Convertibles

Want higher returns with less risk?

Of course you do. That's what every investor wants. Unfortunately, there's an inverse relationship between risk and reward - to achieve high returns, you need to accept more risk.

But that inverse relationship is not absolute. Sometimes relatively safe securities outperform riskier securities.

Convertible securities, for example, can potentially help investors who are heavily invested in stocks to reduce risk while continuing to earn equity-like returns. They can also help investors who are heavily invested in bonds to add growth to their portfolio, while managing risk.

Convertibles, which are typically issued as bonds or preferred stock that can be converted into common stock, provide a stream of income, like a bond, but also have the potential for growth based on the option to convert into shares of the underlying stock.

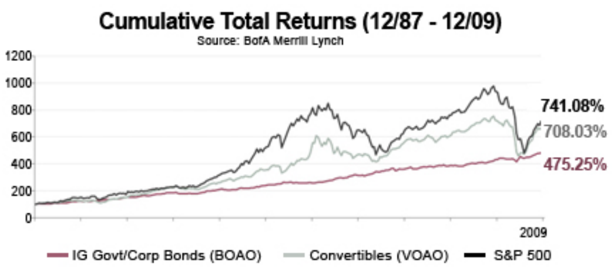
The price of convertibles typically moves within a narrower range of the underlying common stock they convert into. That means they're less risky, but don't have as much growth potential.

However, convertibles also produce income. Add on the income, and total returns may be comparable to returns produced by the equity.

In addition, though, the income provides downside protection, because it continues regardless of the performance of the underlying stock. If, for example, your convertible has a 5% yield, if its price were to fall, the income would provide a buffer, compensating for a 5% fall or reducing the impact of a larger fall in price.

For investors who took money out of the market during the recent bear market, convertibles provide an opportunity to re-invest without having to deal with the level of volatility inherent in the market.

For those who are invested in bonds and are worried about rising interest rates (*see below*), convertibles provide a hedge, as they are generally less susceptible to rising rates than ordinary bonds.



Convertibles historically have provided equity-like performance with less risk.

Convertibles and Asset Allocation

Convertibles can also play a key role in investors' asset allocation strategy, improving the overall risk/reward profile.

For the purposes of simplification, assume you have three categories of assets - stocks, bonds and cash. Should you consider convertibles to be a fourth asset class? If not, do you include them with bonds or stocks?

The best approach is to review the characteristics of each convertible and categorize it appropriately.

Within the equities category, many investors include a subcategory for alternative investments. This subcategory typically plays a defensive role and convertibles are perfectly suited for that purpose.

Conversely, convertibles with high yields, especially where the option is well "out of the money," are more appropriately allocated with bonds.

Q&A

What is the relationship between bonds and interest rates?

When interest rates go up, bond prices go down. When interest rates go down, bond prices go up.

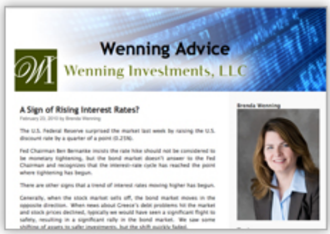
The inverse relationship between bond prices and interest rates is pretty straightforward. Bonds pay a set coupon rate until maturity. The lower interest rates are, the more attractive that coupon rate will be.

If a bond is yielding 5% and the Fed sets interest rates at 2%, the bond is attractive. If the Fed increases interest rates to 7%, the bond becomes unattractive, because investors can earn better returns elsewhere.

Because of interest rate risk, long-term bonds are riskier than short-term bonds.

Our New Blog

Check out our updated and redesigned blog at **www.WenningAdvice.com**.



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Topics we've commented on recently include ...
Investing in bonds in *The Baltimore Sun*.
Exchange-traded notes (ETNs) in Daily Finance.
After-hours trading in the *Boston Business Journal*.
Factors affecting economic recovery in *Fund Strategy*.

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