What is a Convertible bond?

A convertible bond is just like a conventional corporate bond in principle a loan to the company issuing the bond. In return for the loan, the issuer pays interest to the lender (holder of the bond = investor).

Convertible bonds differ from conventional corporate bonds by having a built in right for investors to convert the bond into shares in the company on a fixed date at a predefined price.

The holder of the bond may either chose to convert into shares or receive a cash payment at redemption.

For which investors are convertible bonds relevant?
Convertible bonds are relevant for investors wanting a relatively reliable investment with a relatively safe and stable return, but who are willing to take an extra risk against having an extra return opportunity, which is significantly above what can be obtained on conventional government and mortgage bonds.

Specifically for convertible bonds

Due to the right of converting into shares, convertible bonds will generally have a lower return than other corporate bonds. This means that issue of convertible bonds may be an option for companies, which find that issue of conventional corporate bonds is too expensive. But which are willing to commit themselves to converting the bonds into shares if the company (and the share price) performs well.

In addition, convertible bonds may be an alternative to issuing new shares for the company.

The price of a convertible bond may have the characteristics of both a conventional corporate bond and a share. Whether the convertible bond resembles the one or the other depends on the share price relative to the conversion price.

If the share price is above the agreed conversion price (in the money), the convertible bond resembles a share the most, because in this case it will be profitable to convert. The return, which can be obtained from this, will follow the share price. However, there will often be a cap on the increase of the share price before the company can make a forced conversion. This means that as opposed to shares, there may be a limited upside for convertible bonds.

Conversely, where the share price is below the conversion price (out of the money), the convertible bond will have characteristics that resemble those of an ordinary corporate bond where the return depends on the coupon and price fluctuations of the bond itself.

The value of a convertible bond depends both on developments in the bond and interest rate markets but also on the price of the underlying share.

Pros and cons

Convertible bonds	
Pros • By assuming an extra risk, investor gets a return opportunity that is significantly above that of conventional government and mortgage bonds. • Investor receives regular interest payments. • Good supplement to an equity portfolio. • Contains an option to convert to shares.	**Cons** • Convertible bonds involve greater risks than investment in government and mortgage bonds. • Some issues are traded on a non-regulated market. • Risk of forced conversion if the share has reached a specific cap on how much higher the share price can go relative to the conversion price.

What happens in practice?

To buy bonds you must have available in your account the full purchase amount. After the purchase, you will regularly receive interest on the bond. The price of the bond is determined by supply and demand and by investors' expectations of the issuing company.

Return

The total return depends on both the price and the yield on your bonds. If you purchased a bond with a fixed coupon rate, you can expect fixed interest income. The price may vary over time and may influence your total return if you sell the bond before maturity. The return of convertible bonds also depends on the share price of the company. If the share price of the company is higher than the conversion price, a higher return can be obtained by converting the bond into shares.

About risk

The price may change if there is a change in the creditworthiness of the issuer of your bond, which for most bonds is expressed through a rating. Typically, a low rating means a higher risk of default. Ratings are issued by credit rating agencies (e.g. Moody's, S&P and Fitch) and they have different scales ranging from the best to the poorest rating. You should therefore consider the rating of the bond. Typically, there is a correlation between the credit rating of the issuer, the risk and the expected return. The lower the credit rating, the higher the risk and the higher the expectation of returns.

Prices on your bonds fluctuate in step with changes in the interest rate level. This is especially true for fixed-rate bonds as the price on these bonds will rise when interest rates fall and the price will fall when interest rates rise. The longer the maturity of your bonds, the more sensitive the price will be to changes in the interest rate level.

If you invest in a bond denominated in another currency (for instance, euro) than your base currency (for instance, the British Pound), you assume a currency risk.

When using benchmarks (e.g. interest rate benchmarks) in convertible bonds, you must be aware of the risk that these benchmarks are or can be subject to national, international or other initiatives, which may mean that the composition of the benchmark is changed or that the benchmark completely disappears.

Further information is available at:
trustednovusbank.gi/general-terms/fallback-plans

The risk classification of convertible bonds may be either red, amber or green with red denoting the most risky bonds.

Read about the risk classification of investment products at:

trustednovusbank.gi/investmentinformation

When you trade convertible bonds, please be aware that in respect of tax they may be regarded differently to shares.

We recommend that you seek advice from professional advisers about any accounting and tax consequences before you buy convertible bonds.

Tax

We do not give advice on tax issues in connection with specific transactions.
If you wish to learn about the specific importance of the tax rules for you, we recommend that you consult your accountant.

What you should know before trading

We recommend that your investment profile is reviewed before you engage in transactions. Your relationship manager can help you with that. We also recommend that you contact your relationship manager if you have any questions in relation to anything described in this fact sheet, or if, generally, you would like to have some points clarified.

Most liquid convertible bonds are fairly transferable in connection with a sale. However, investors should be aware that especially non-liquid convertible bonds may at times be hard to sell and that this risk is often increased by market unrest.