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These Funds Are Making a Conversion of Sorts

By Aaron Lucchetti And Tom Lauricella

Convertible Bond mutual funds specialize in buying securities that start life as bonds and later can change into stocks. But recently it has been some convertible-bond managers who have been converting their entire funds into something new.

Calamos Investments, a convertible-bond specialist that is one of the best-known investors in the securities, earlier this year dropped the word "convertible" from the names of its $1.6 billion **Calamos Convertible Growth & Income Fund** and its $51 million **Calamos Global Convertible Fund**. And in a few days the $200 million **Davis Convertible Securities Fund** will give its name an overhaul and start calling itself the Davis Appreciation & Income Fund.

Why the conversion of these convertible funds?

In a letter to fund shareholders, Calamos founder John Calamos explained that the changing state of the convertible-bond markets was "making it difficult to find appropriate [convertible] holdings" for his firm's funds. Jason Voss, a portfolio manager for the Davis fund, puts it more bluntly, "There's no way you'll ever make money" in some of the new convertible bonds available to mutual-fund investors today, he says.

While 2003 has been stellar for new convertible bonds being issued by companies and a strong year for investment gains in convertible issues – the average convertible fund has gained 12% this year – a number of convertible funds are saying they have to look at other types of securities to fill out their portfolios. The main reason: many of the convertible bonds being sold by companies today are designed to appeal more to hedge-fund managers than mutual-fund managers.

So funds like the Davis and Calamos portfolios are amending their investment mandates to include other types of securities beyond convertibles. Such changes pose questions for investors, especially those who have purchased the funds specifically due to the portfolios' focus on convertible securities. And while the Calamos and Davis funds plan to include convertibles as a major part of their strategies, investors need to consider that their track records were accumulated with an investing style that has since been altered.

Even with the changes in the convertible market recently, investors have been flocking to convertible funds. The two dozen or so convertible mutual funds available have attracted more than $1 billion in net new assets this year through April 30, nearly quadrupling the new money that flowed into the sector during the first four months of 2002.

Convertible bonds have proven an attractive niche for investors who like to get both the price potential of a stock and the interest income of a bond. Convertible securities are sold to investors as bonds, which pay interest and promise to repay the principal at the bond's maturity.

But unlike a regular corporate bond, they can also convert into shares of a company if the stock price goes up. So two of the most important factors that fund managers look for in convertibles are interest payments that are as high as possible and the likelihood that it will be worthwhile to convert the bonds into stock without the shares having to make a big price move.

This year, though, many of the new convertible deals have featured very low interest coupons and terms that make conversion into stock less likely. "We have laughed at some of the terms" that investors are being asked to pay on new convertible issues, says Davis's Mr. Voss.

Mr. Voss says the change in the Davis fund's name, which will be effective Tuesday became necessary as the terms on new deals in the convertible market went from "bad" to "worse" this year. Another factor in the decision to make the fund's name less specific was a Securities and Exchange Commission rule that went into effect last year requiring mutual fund assets to keep at least 80% of their assets in securities that correspond with their names.

"We're gong to continue doing what we have been doing, but broaden our scope a little bit," says Andrew Davis, another portfolio manager on the soon-to-be-named Davis Appreciation & Income Fund. One tactic the fund may use instead of buying convertibles will be to buy bonds and stocks of the same company in an effort to get both potential gain and some interest income.

To be sure, most convertible funds haven't announced plans to change their name or strategy. But many have still been shunning new convertibles deals and looking elsewhere for more attractive purchase candidates.

David L. King, manager of **Putnam Convertible Income-Growth Trust**, says his fund has avoided many of the new convertibles in the technology and Internet sector, such as deals recently offered by **Yahoo** Inc. and **Ask Jeeves** Inc.

At the same time, Mr. King says he has found some attractive convertibles from smaller companies issuing debt. While buying debt of lesser-known companies may be less advisable for individual investors, it makes more sense for a fund company with its own research staff, he says. Most recently, he has bought the convertibles of **Sierra Pacific Resources,** an electric utility, **Guitar Center** Inc., a small-cap retailer, and **Zenith National Insurance** Corp., an insurer Mr. King says will benefit from growth in workers' compensation premiums.

Northern Income Equity Fund, which also focuses on convertibles, has steered more in recent months to buying stocks instead of convertibles. Ted Southworth, the fund's manager, says he likes stocks with high dividends, especially after the recent dividend tax cut. Mr. Southworth has also sought out bargains among older convertible bonds. As for new deals, he says he hasn't found many attractive. "We've been sitting on the sidelines more than usual," he says.

Calamos, which also altered the investment guidelines on its flagship $1.3 billion **Calamos Convertible Fund,** made the changes to maintain the firm's long-term goals of providing convertible-fund investors between 70% and 80% of stock market returns with about a third the risk of a stock-market decline, says Nick Calamos, the firm's chief investment officer. The moves were "not changes in the investment strategies," but were designed to give the funds "more flexibility," he said.

How could the convertible market be doing well if so many fund managers are skeptical? Part of the reason is that hedge funds have grown to be more important buyers of new deals, accounting for an estimated 60% of the convertible purchases now, up from about 20% five years ago. And since those hedge funds often use convertibles as part of a larger arbitrage strategy, they don't care as much about the most important factors for the more buy-and-hold mutual fund crowd. "Deals are being structured more for hedge funds right now, because the hedge funds are willing to pay more," says David Ballard, head of convertibles at Credit Suisse First Boston.

After a particularly busy period in the last two months, 143 convertible bond offerings have been sold to investors this year, up from 121 in 2002 and on pace to beat the record year of 2001, when 211 deals were sold, according to Morgan Stanley's ConvertBond.com.