Keep This Hybrid in Mind If You're Seeking Income

Description

With bond yields bouncing along at historical lows, credit spreads reasonably tight, and dividend paying stocks bid into the top valuation tier, Canadian investors are running out of attractive ways to get their income fix. An option that is often times overlooked is the convertible debenture.

What's that?

A convertible debenture is sort of a hybrid between a corporate bond and a stock. When first issued, they look like a bond. There is a regular coupon, a maturity date, and the issue price is typically par. However, strapped to this ordinary looking bond is an equity-linked conversion option. This gives the owner the option to "convert" the bond into the company's stock at a pre-determined exchange ratio, if the price of the stock climbs to a certain level.

The security effectively blends the security of a bond with the upside of an equity. As long as you're buying into a financially sound company, the worst that you will do with a convertible debenture is receive a regular coupon payment and get your money back at the maturity date.

However, if the company's stock takes off and exceeds the conversion price, you will participate on the upside. The debenture's price will tend to move with the stock once the conversion price is cleared. This is known as being "in the money". Limited downside and upside optionality are welcome attributes with any investment.

Sounds too good to be true

Theory and practice aren't necessarily aligned in the Canadian convertible bond market. The downside protection is legit, again, as long as you're dealing with a financially sound entity. The optionality provided by the conversion feature is slightly less so. Many of the convertibles in the Canadian market trade with a very wide gap between their current stock price and the conversion price. On average, this gap is 112%, however, outliers have a significant impact on this figure as the median difference is only 32%. Selection is important if you want that upside kick.

How do I buy these things?

Convertible debentures trade on the TSX just like an ordinary stock. There is no magic involved with transacting in them. Typically they have a ".DB" added to the ticker symbol of the underlying equity. XYZ.DB for example.

There is some magic involved in knowing which companies offer this kind of security, but the National Post appears to offer a comprehensive list here.

The Foolish Bottom Line

Canada does not have a very well-developed corporate bond or high yield debt market. Income trusts served this purpose for many years. With the disappearance of trusts, convertible debentures are likely to play an increasingly important role in this country's capital markets. You'll be ahead of the game and ready to profit if you begin following these hybrids before they truly go mainstream.
In our next post, we'll have a look at 2 convertible debenture ideas to help get you started.

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