New players to the investing game often ask what convertible bonds are, and whether they are bonds or stocks. Essentially, they are corporate bonds that can be converted by the holder into common stock of the issuing company. In this article, we'll cover the basics of these chameleon-like securities as well as their upsides and downsides.

**What Is a Convertible Bond?**
As the name implies, convertible bonds, or converts, give the holder the option to exchange the bond for a predetermined number of shares in the issuing company. When first issued, they act just like regular corporate bonds, albeit with a slightly lower interest rate. Because convertibles can be changed into stock and thus benefit from a rise in the price of the underlying stock, companies offer lower yields on convertibles. If the stock performs poorly there is no conversion and an investor is stuck with the bond's sub-par return (below what a non-convertible corporate bond would get). As always, there is a tradeoff between risk and return.

**Conversion Ratio**
The conversion ratio (also called the conversion premium) determines how many shares can be converted from each bond. This can be expressed as a ratio or as the conversion price, and is specified in the indenture along with other provisions.

**Example**
A conversion ratio of 45:1 means one bond (with a $1,000 par value) can be exchanged for 45 shares of stock. Or it could be specified at a 50% premium, meaning if the investor chooses to convert their shares they have to pay the price of the common stock at the time of issuance plus 50%. Basically, these are the same thing said two different ways.

This chart shows the performance of a convertible bond as the stock price rises. Notice that the price of the bond begins to rise as the stock price approaches the conversion price. At this point your convertible performs similarly to a stock option. As the stock price moves up or becomes extremely volatile, so does your bond.

It is important to remember that convertible bonds closely follow the underlying's price. The exception occurs when the share price goes down substantially. In this case, at the time of the bond's maturity, bond holders would receive no less than the par value. In a 1995 study by Merrill Lynch on technology convertible bonds it was found that converts provided 70% of the upside potential of the common stock, on average, while providing much higher protection on the downside, as the price of convertibles demonstrated smaller losses than the stock in all but one month over the study's duration.

**Forced Conversion**
One downside is that the issuing company has the right to call the bonds. In other words, they have the right to...
forcibly convert them. Forced conversion usually occurs when the price of the stock is higher than the amount it would be if the bond were redeemed, or at its call date. This attribute caps the capital appreciation potential of the convertible bond. The sky is not the limit with converts as it is with common stock.

The Numbers
As we mentioned earlier convertible bonds are rather complex securities for a few reasons. First they have the characteristics of both bonds and stocks, confusing investors right off the bat. Then you have to weigh in the factors affecting the price of these securities; these factors are a mixture of what is happening in the interest-rate climate (which affects bond pricing) and the market for the underlying stock (which affects the price of the stock). Then there’s the fact that these bonds can be called by the issuer at a certain price that insulates the issuer from any dramatic spike in share price. All of these factors are important when pricing convertibles. Here our goal is offer a simple explanation, or the foundations, from which to further your knowledge.

Example
Let’s say that TSJ Sports issues $10 million in three-year convertible bonds with a 5% yield and a 25% premium. This means that TSJ will have to pay $500,000 in interest annually, or a total $1.5 million over the life of the converts.

If TSJ’s stock was trading at $40 at the time of the convertible bonds issue, investors would have the option of converting those bonds for shares at a price of $50 ($40 x 1.25 = $50). Therefore if the stock was trading at say $55 by the bond’s expiration date, that $5 difference per share is profit for the investor. However there is usually a cap on the amount the stock can appreciate through the issuer’s callable provision.
For instance, TSJ executives won’t allow the share price to surge to $100 without calling the converts (recall the paragraph on forced conversion). Alternatively, if the stock price tanks to $25 the convert holders would still be paid the face value of the $1,000 bond at maturity. This means that convertible bonds limit risk should the stock price plummet, while limiting exposure to upside price movements of the underlying common stock.

Conclusion
Getting caught up in all the details and intricacies of convertible bonds can make them appear more complex then they really are. At their most basic, convertibles provide a sort of security blanket for investors wishing to participate in the growth of a particular company they’re unsure of. By investing in converts you are limiting your downside risk at the expense of limiting your upside potential.

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