

A Review of the
Convertible Securities
Market

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Convertible Securities as an Asset Class

Overview

Convertible securities are interest and dividend paying securities, similar to corporate bonds and preferred stock, in which investors have the option to exchange them for a predetermined number of shares of common stock or, in some instances, the dollar value of that stock. The hybrid nature of the securities offers investors the principal protection and income characteristics of bonds with the opportunity for higher returns if the issuer's stock price rises. Convertible securities are senior to common stock in a company's capital structure.

These securities are attractive because they historically have been able to provide returns that are highly competitive with common stocks in average equity markets, outperform in poor equity markets and participate in strong equity markets. Over multiple market periods their total returns have been competitive with those of the equity markets but with less volatility. As of 9/30/11, the Bank of America Merrill Lynch All Convertible Index (VXA0) outperformed the S&P 500 for the 3, 5 and 10 year periods with lower volatility. It is the hybrid nature of convertibles that makes it difficult to compare them to other investments. Standard equity analysis does not account for the investment value of these securities and fixed income analysis misses the value of the embedded option to convert into common shares.

The purpose of this paper is to examine the current domestic convertible securities market, to look at the advantages, risks and returns of convertibles and to consider current analytical tools used to value these instruments.

Market Size

As of 09/30/2011 the U.S. convertible market had a market capitalization in excess of \$209 billion with nearly 600 issues representing over two trillion dollars of underlying common equity from approximately 500 issuers¹. This market is far more liquid than the \$209 billion market capitalization implies. Since brokerage firms and hedge funds can arbitrage between the convertible and its underlying common stock, the liquidity of the common will affect the market for the convertible security. For issues where the common shares can be easily borrowed, a short position in the common can be set up as a hedge against a long position in the convertible. This

¹ Data source: Barclays Convertible Market Watch September 2011

can reduce the risk of taking on the convertible (or even lock in a profit) making it attractive for brokers to actively engage in the buying and selling of most issues. We will discuss why this works later in this paper. The actual liquidity of convertibles is similar to the liquidity of the \$970 billion High Yield Corporate market (the JOA0 index from Bank of America Merrill Lynch)².

Different Types of Convertible Securities

There are three fundamental types of convertible securities that make up almost all of the US domestic market today. These are: convertible bonds, convertible preferred shares and mandatory convertible preferred shares.

Convertible Bonds

Convertible bonds make up the largest part of today's market with approximately an 80% share of the outstanding capitalization³. In most cases, convertible bonds are exactly that: bonds that can be exchanged at the option of the holder into a predetermined number of shares of a specified common stock. They tend to have the usual features of bonds issued by a corporation; they pay a set coupon, have a cash redemption value at maturity if not converted or called and are issued with call protection for a specified time period. They are debt, not equity, so they are senior in the issuer's capital structure to all common and preferred shares and holders have the right to put the issuer in default if they do not meet the obligations in the indenture. While convertible bonds may be issued at any level within the capital structure, they are typically issued as senior subordinated or subordinated debentures, the lowest level of debt in the capital structure.

Convertible Preferred Shares

Convertible preferred shares make up approximately 11% of the convertible market⁴. These are equity in the corporate structure and as such rank below all debt in the capital structure although they do rank above the common shares. As preferred stock they pay dividends that are usually, but not always, qualified dividends for income tax purposes. The dividends tend to be

² Source Bank of America Merrill Lynch

³ Source Bank of America Merrill Lynch

⁴ Source Bank of America Merrill Lynch

higher than that of the common stock and the conversion rate will typically increase (convertible into more shares) with any increase in the common dividend. While preferred dividends can be cut in times of corporate distress, the prospectus typically encourages companies to pay them by mandating that they are paid in full before common dividends are paid. They can be converted into a predetermined number of common shares at the holder's option, are often issued with call protection and if issued as a Trust Preferred they have a maturity date.

Mandatory Convertible Securities

Mandatory convertible securities are an interesting variant of the standard convertibles discussed above. The ratings agencies treat them as equity in the capital structure because they will be converted at a specified time. While they make up only about 9% of today's convertible market capitalization⁵, they once made up one sixth of the convertible market and may do so again as issuers view them as an attractive financing option. They come in the form of preferred shares with a higher dividend than common shares. The income is typically in the form of qualified dividends for income and tax purposes. Where they differ from the convertible preferred shares discussed previously is in the conversion feature: they are not convertible at the holder's option, they automatically convert on a specific date into a number of shares determined by a formula based on the price of the common shares. This can lead to a conversion into shares worth less than the original issue price if the common stock price has declined. If the stock has not fallen, then the holder will receive shares worth at least the original issue price or may participate in a portion of the profit of the common stock. The primary advantage to the investor of mandatory issues is their dividend is often substantially higher than that of a standard convertible preferred stock. The disadvantage to the investor is that the typical mandatory convertible structure utilizes a call spread model which exposes the holder to both upside and downside participation that can be substantial. The advantage for the issuer is that mandatory convertibles do not pose a credit risk later for the company since they eventually convert to equity.

⁵ Source Bank of America Merrill Lynch

Who Issues Convertibles and Why

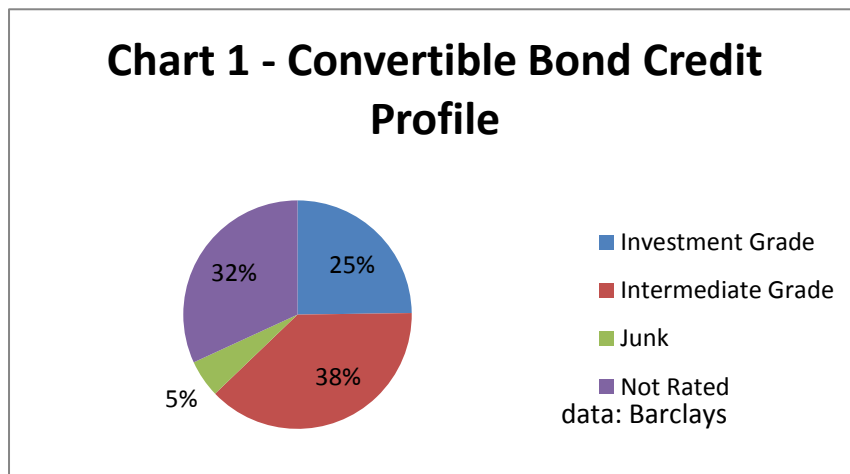
Convertibles are issued by a broad range of companies in many different industries (see Table 1). Typical convertible issuers are just below investment grade and come to the convertible market for the reduced cost of capital that it can provide. Convertibles have lower coupons and fewer covenants than the High Yield straight debt these companies would issue. They also allow management to sell equity at a premium to the current price since the conversion price is higher than the common stock price is at issue (usually by 25 to 40%). Companies may also issue convertibles to broaden their investor base, have a more flexible capital structure, or to help reduce or defer some tax liabilities. Some convertible issuers don't pay a dividend on their common stock which can limit some investors from owning the stock. The issuance of a convertible allows those investors to be able to invest in a particular company.

New Issues vs. Outstanding Issues

Investments in convertible securities can be chosen from outstanding convertibles in the secondary market, as well as new issues. New issues are typically announced 24-48 hours prior to being sold, allowing an investor time to familiarize themselves with the company and the terms and conditions of the convertible offering. Management hosts a conference call during the offering period to present an overview of the company, present the terms and conditions of the offering and field questions from investors. Once the new convertible security begins trading, there is significant liquidity for the new issue for at least the first week. While still quite liquid, trading settles into more normal levels after this period. Outstanding convertibles offer a slightly different investment. Liquidity will vary based on investor interest in the issue and the liquidity of the common stock. The convertible price may be trading in a very different range than it was at issue due to changes in the stock price. Outstanding issues may offer more attractive yield and premium levels. If issues trading in the secondary market are trading below par (issue price) they may have a current yield or a yield to put making them even more attractive in a diversified portfolio. In any case, it is very important to analyze both new and outstanding issues for potential investments.

Diversification: Convertible Market Credit Exposure and Sector Exposure

Bank of America Merrill Lynch (BAML) breaks the market's credit quality down into three parts: Investment grade convertible issues which made up roughly 29% of the capitalization of the convertible securities market in 2011, speculative grade issues which made up 38% and unrated issues which made up about 33%⁶. Barclays uses four parts in its analysis by splitting the speculative grade in two parts and including smaller issues with very low ratings: Investment Grade (BBB- and above) is 28%; Intermediate Grade (B- to BB+) makes up 43% Junk (below B-) is 6% and Non Rated is 36%⁷ as seen in Chart 1 below. This provides the investor with an ability to measure their level of credit risk and to diversify over different credit levels within a convertible portfolio.



Convertible issues today are available from an array of issuers from many different industries. Table 1 which follows shows the different sectors and their position in the convertible marketplace. While the sector exposure does not exactly match that of the broad equity markets, there is substantial diversity available to build a portfolio. There are certain industries such as financials, technology, energy and healthcare that have a history of issuing convertibles. Financial companies are attracted to the low cost of capital converts can provide, while companies in technology and other growth sectors find it appealing to sell equity at a premium.

⁶ Bank of America Merrill Lynch

⁷ Barclays Convertible Market Watch September 2011

Table 1 - Convertible Market Sector Exposure

<u>Equity Sector</u>	<u>Market Capitalization Billions</u>	<u>Percentage of Market</u>
Technology	\$47.4	23.12%
Finance Institutions	\$40.3	19.66%
Consumer Non-Cyclical	\$39.0	19.02%
Consumer Cyclical	\$16.2	7.90%
Utilities	\$15.9	7.76%
Basic Industry	\$14.7	7.17%
Communications	\$10.9	5.32%
Capital Goods	\$10.8	5.27%
Energy	\$5.1	2.49%
Transport	\$4.2	2.05%
Industrial Other	\$0.5	0.24%
Total	\$205	

Data source: Barclays as of September 30, 2011

Convertible Investment Strategies

Dinsmore Capital Management has conducted a study of the convertible market, as represented by the Bank of America Merrill Lynch All Convertible Index (VXA0), to test the hypothesis that convertibles can perform competitively against equities and do so with less volatility. The performance of the convertible index was compared with the performance of the S&P 500 stock index and the performance of the common stocks that underlie the convertibles in the index. In this study we have included the 1, 3, 5 and 10 year numbers. Our thesis is that a full market cycle best represents the measure of the value proposition of convertibles. The results are shown in Table 2⁸:

⁸ Data source: Bank of America Merrill Lynch. Returns shown are compound annual growth rates.

Table 2 - DCM Study of Convertible Performance and Volatility

Returns	BAML All Convertibles		S&P 500 Index		Underlying	
	Index (VXA0)				of VXA0 Index	
To 9/30/11	Annual Returns	Std. Dev.	Annual Returns	Std. Dev.	Annual Returns	Std. Dev.
1 Year	-2.31%	10.90%	1.15%	13.70%	-9.65%	20.95%
3 Years	8.80%	17.27%	1.22%	21.25%	2.49%	32.18%
5 Years	2.23%	15.91%	-1.18%	18.32%	-3.81%	27.12%
10 Years	5.14%	12.72%	2.81%	15.74%	2.48%	24.68%

The study shows that the hypothesis is reasonable as the convertible index outperformed the S&P 500 index over three of the four periods shown and outperformed the common stock underlying those convertibles across every period ended September 30, 2011. It also shows that the returns were less volatile for the convertible index than either group of common shares. What really stands out, however, is the convertible comparison with their underlying common shares. Not only did the VXA0 outperform the common underlying the convertibles over all periods, but it did so with substantially less volatility.

From this data one can draw the implication that many convertible offerings are issued by speculative companies. This was noted many years ago by Professors Graham and Dodd in the 1940 edition of their book ‘Security Analysis’⁹. What has changed today is that along with the speculative issuers, there are many higher grade companies that have made convertibles available to investors as was shown previously in Chart 1.

With this information on performance it appears possible to use convertible securities to populate a portfolio that is likely to be less volatile while still providing total returns that are competitive with common stock returns.

⁹ Graham, Benjamin and Dodd, David L. *Security Analysis* 2nd Ed. (New York: McGraw-Hill 1940) pp. 284-294

Analysis & Valuation

As shown in Table 2 convertibles have been a very attractive relative performer as an asset class but, as in any asset class, not all issues will compete profitably. It is important to analyze the characteristics of each issue and where it is in its life cycle relative to its underlying common shares and to all the protections accorded to each issue at its initial offering.

It is imperative to examine the prospects for the underlying common stock as well as to determine the issuer's credit worthiness from their financial statements to see whether they are likely to be able to meet the obligations of the issue. The value of a convertible will reflect the prospects of the company and its financials. If the financials are weak and the company's growth prospects speculative, then the convertible may be as risky as the common stock.

When examining specific convertible issues relative to other investments, there are several analytical tools that can be used to judge the potential risk and reward of that convertible security. They include the investment value of the convertible, the conversion value of the convertible, yield advantage of the convertible over its common stock, break-even calculation and the equity sensitivity of the convertible. Each of these tools is explained in the next section of this paper. Generally speaking, all of these tools should be used in valuing the issue under consideration. These tools are very useful with convertible bonds and preferred shares but since mandatory convertibles must be converted into common stock and their value at conversion may not add up to the issue price, investment value analysis is less useful for these issues.

Investment Value

Investment value is the market level that a convertible issue would have if it had no conversion privilege. This is often referred to as the "bond floor". Determining investment value or bond floor requires a comparison to similarly rated, non-convertible issues from the same company (or a similar company, if necessary) with matching (or close) maturities. The yield provided by those issues will give a useful approximation of the yield level to be used to figure investment value for the convertible being analyzed.

A \$1000 convertible bond with a 4% coupon and 5 years until a put date or maturity would have an investment value of \$750 if the company's similarly rated non-convertible bond were selling on the market with a 10.6% yield to maturity and 5 years until a put date or maturity. A convertible bond's investment value is based on its comparative yield to maturity (or yield to put) and its relative place in the company's capital structure.

Premium to investment value is the difference between the market price of the convertible and its investment value, usually stated as a percentage of that value. In the example above, if that convertible bond was trading at \$1000 then the premium to investment value paid would be calculated as \$1000 minus \$750 or \$250. To express this as a percentage, the \$250 is divided by the investment value of \$750 which figures to 33%. The \$250 is considered the implied value of the embedded option.

Conversion Value

Conversion value, also known as parity or intrinsic value in option terms, is simply the value of the convertible issue if it were to be converted into common stock at the current stock price. A bond which is convertible into 20 shares of stock with a price of \$40 is worth 20 multiplied by \$40 which equals \$800. The formula is the same for preferred shares.

At the issue offering, the convertible security's right to convert into a set number of common stock shares is calculated. The conversion ratio or the specific number of shares each issue is convertible into is in the issue's indenture or prospectus. This simple calculation is done by dividing the bond issue price by the conversion price.

In the example above the convertible was issued at a 25% premium to its common share price of \$40 which is \$50 a share. If we divide the issue price of \$1000 (also known as par) by the conversion price of \$50 we can determine the conversion ratio to be 20 shares per bond. The conversion price is also the strike price of the embedded option.

Conversion premium or premium to conversion value is the difference between the market price of the convertible and the value of the underlying shares or parity. Usually expressed as a percentage, the formula is straightforward. First subtract parity from the market price. In the bond example above, if the market price is \$1000 and parity is \$800 then the difference is \$200. This is the dollar premium. Then take that \$200 and divide it by parity (\$800) and that comes to 25%. Convertible bonds, like straight bonds, are usually quoted in terms noting prices as a

percentage of par, usually \$1000. So the above example would quote the bond price at par (100) and parity at 80. The difference between them is 100 minus 80 which is 20 points of premium. The difference 20 is then divided by parity 80, which comes to 25%.

Yield Advantage

Most convertible securities pay a higher rate of current income than the common stock underlying the convertible. This is known as the yield advantage. If we have a convertible bond selling at par with a 4% coupon and the underlying common stock has a 1% dividend we can determine that at a \$1000 investment in the bond would yield \$40 per year and that an equal dollar investment in the common stock would yield \$10 per year. In this example the bond would have a yield advantage of \$30 per year; this is also sometimes expressed as 3%.

Break-Even

Break-Even, or Payback Period, is a measure of the time that the yield advantage would take to pay back the conversion premium. Using our bond example, if there is a dollar conversion premium of \$200 and a yield advantage of \$30 per year, the time that \$30 takes to pay back \$200 is determined by dividing the premium (\$200) by the yield advantage (\$30) or 6.67 years. Because this formula does not take into account net present value as well as the value of a bond floor with a maturity, this analysis is often used only to compare similar bonds. Break-Even analysis does work well with mandatory issues for long-only holders since these are often priced to be common stock alternatives.

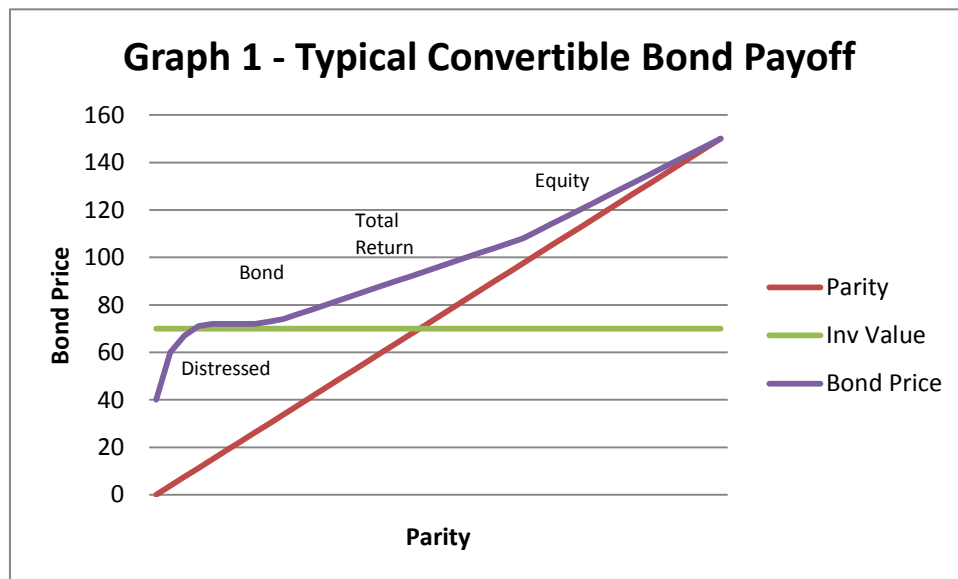
Equity Price Sensitivity

Knowing how sensitive a convertible is likely to be to movements in the underlying common stock is essential to judging the risk and reward of the issue. The relationship between the expected price change of the convertible and the price change of the common stock is known as delta. The range of expected values for delta starts at zero 0%, where the convertible price is insensitive to a change in the common price, and goes to 100% where the convertible price would move in lockstep with any change in the common price. A delta of 0% would be expected when the convertible is priced at or near its bond floor and a delta of 100% would be expected when the underlying stock price is well above the conversion price. Delta values are an inverse

function of the size of the conversion premium, which is to say that the larger the conversion premium, the smaller the delta (less equity sensitive) and the smaller the conversion premium, the higher the delta or equity sensitivity.

Gamma is a measure of the rate of change of delta with changes in the price of the common shares. For the mathematically inclined, it represents the second derivative of the slope of the line depicted in Graph 1 below. It can help detect inflection points in the price of the convertible. It is useful since it can point to convertibles where the reward from a rising stock price is higher than the risk of a falling stock price.

Investment Approaches



The primary convertible investment strategy is as an alternative to common stock in an equity portfolio. As seen in the DCM Study of Convertible Performance and Volatility (Table 2), broad portfolios of convertible securities have shown the ability to compete with equity indices on a total return basis over full market cycles. They have accomplished this with less volatility in those returns.

Within portfolios that utilize convertibles to meet their investment objectives, there are five general approaches: Equity Equivalent, Total Return, Fixed-Income Equivalent, Distressed and

Hedged. Appropriate issues for each of these strategies can be determined by examining each within the analysis outlined above.

Equity Equivalent

Convertibles that sell at prices near parity (the underlying equity value) and have high deltas (perhaps over 0.75 or 75%) provide returns that correlate closely to the returns of the underlying common stock. If there are no technical deficiencies in the convertible, such as the proximity of a call date or a yield deficit in comparison to the common, then that convertible may be a desirable replacement for the common shares. These high delta issues will still retain some downside protection due to maturity, seniority and yield even if they have most of the common's upside potential. On the convertible graph (Graph 1), these issues would fit towards the upper right on the convertible pricing line near the spot marked "Equity".

Total Return

This is the most common approach to running a long-only portfolio of convertibles. The convertible issues that would fit into the total return category would have a moderate premium to conversion value (perhaps 20% to 50%), a significant yield advantage to the common (generally more than 150 basis points or 1.5%), deltas in the range of 0.35 to 0.75 (35% to 75%) and downside protection due to maturity, seniority and/or yield. On the convertible graph (Graph 1), specific issues considered for this group would fit towards the middle on the convertible pricing line near the spot marked "Total Return." A portfolio designed for total return could also be made up of a diverse mix of issues from the equity equivalent issues and the fixed income category (this is known as a barbell strategy) along with actual total return issues. Historically this approach best fits the fundamental experience of convertibles: it usually outperforms in flat and down markets, it is competitive in average markets and it participates in strong markets.

Fixed Income Equivalent

Convertibles can be used to assemble a portfolio of issues that have yields comparable to those generated by similar non-convertible fixed income securities. These issues are trading near their bond floors (delta below .35 or 35%), have a high premium and are often referred to as "busted" convertibles. While the probability of any one of these issues recovering from its

“busted” status due to the upward movement in the underlying common stock is modest, it can and does happen. When this occurs the portfolio can generate unexpected capital gains.

Distressed

When a company threatens to go into default or actually goes bankrupt, convertibles, which are senior to the common stock in the company’s capital structure, may retain significant value. Professional investors who specialize in distressed companies have often found value in these convertible issues worth investigation. On the convertible graph (Graph 1) these issues would fit on lower left near the spot marked “Distressed”.

Hedging or Convertible Arbitrage

Convertible arbitrage is a market neutral investment strategy often associated with hedge funds. This strategy primarily involves taking long positions in convertible bonds or warrants, hedged with a short position, typically in the underlying stock. Convertible bonds and warrants (as derivatives) are priced as a function of the price of the underlying stock, expected future volatility of returns, risk-free interest rates and the issuer-specific corporate over treasury securities yield spread. However, in many cases, convertible bonds and warrants are not accurately priced due to the nuances of their respective over-the-counter markets as compared to the markets in the underlying common stocks, uncertainty concerning the call or redemption features of convertible securities and lesser market focus on these derivatives as opposed to the equities into which they are convertible or exercisable. These mispricings may give rise to significant profit opportunities, as positions are acquired in anticipation of the market price eventually reflecting true value. The premise of the strategy is that the convertible is sometimes priced inefficiently relative to the underlying stock, for reasons that range from short term selling pressure to market psychology. In particular, the equity option embedded in the convertible may be a source of cheap volatility when compared to the underlying common stock’s listed options, which convertible arbitrageurs can then exploit. The number of shares sold short usually reflects a delta neutral or market neutral ratio. As a result, under normal market conditions, the arbitrageur expects the combined position to be insensitive to fluctuations in the price of the underlying stock. However, maintaining a market neutral position may require rebalancing transactions, a process called dynamic delta hedging. This rebalancing adds to the return of

convertible arbitrage strategies. As with most successful arbitrage strategies, convertible arbitrage has attracted a large number of market participants, creating intense competition and reducing the effectiveness of the strategy. In 2008 and the beginning of 2009 the deleveraging of the financial system proved costly to the convertible arbitrage strategy because of exaggerated credit spreads, prohibitions on selling short stock in certain industries and the implosion of the prime brokerage business following the bankruptcy of Lehman Brothers. The pressures of deleveraging have since abated and the convertible market for long only strategies continues to be very attractive on any historical measure.

Risks/Advantages of Convertible Investing

Hedge Fund Investors vs. Long-only Investors

There have been occasions, especially during periods of low interest rates, when hedge funds have come to dominate the trading of convertibles. When this occurs, pricing may be affected by those hedge funds. There are positives that can come out of these periods, however; the first is that positions already held in the long only portfolios are likely to have appreciated in price and the second is that desirable issuers may be drawn by attractive pricing to bring new convertible offerings to the marketplace. Hedge funds are also helpful in regard to liquidity because they trade and invest for different reasons than the long only community.

Market Breadth

While the current market makes convertible securities available in a broad array of sectors and industries, that representation does not exactly match that of the equity market. There are many companies and a few industries that do not have issues available for the portfolio manager to choose from. This can make any ‘top-down’ investment approach difficult at times when companies or industries that fit the theme have not issued convertibles. Because of this, the best approach to constructing a convertible portfolio tends to be a ‘bottom-up’ approach starting with the available convertible issues.

Calls and Call Protection

Most convertible issues may be subject to being called by the issuer at some defined date in the future. Calls will affect the return to the holder, especially when the issue is trading above the specified call price with any meaningful premium to conversion value. When an issue is called, it is likely that the holder will lose all or part of any premium that the convertible was trading with before the call notice. Fortunately, all issues have some call protection at issue which comes in three forms. Hard call protection makes the issue not callable under any circumstances by the issuer through a fixed date in the future which is usually before the maturity date. Soft call protection requires that before the issue can be called the stock price has to exceed, by a stated percentage and a stated period of time, the conversion price of the issue. Finally, some issues are not callable for the life of the security. The exact dates of any call and the specific rights of the investor for the interest or dividend payments from the company to the holder of the issue are clearly spelled out in the issue's indenture.

Takeover Protection

When an issuer of a convertible is acquired, the holder has the right to the same consideration that ordinary shareholders receive through conversion of the convertible security. This is not always entirely beneficial to the convertible holders, so most convertible issues have protection in the event of a fundamental change of control of the issuer. These protections usually come in the form of change of control put provisions and make-whole provisions.

The change of control put allows the holder to demand a set price (usually par) upon the occasion of a change of control of the issuer. If an issuer were to be bought for cash at a price below the conversion price, the embedded option may become worthless and the holder would hold a piece of fixed income paper with parity below par and no conversion rights into the new company.

If parity is above issue price (par) the holder is entitled to a make whole provision that compensates the investor for some part of the conversion premium or coupon payments that would be lost otherwise. The make-whole premium that is payable to the investor upon conversion is determined by using a methodology clearly expressed in the indenture which references a value of an option embedded in the convertible security or is related to the lump-

sum payments made equal to the net-present-value of future coupon payments not paid because of the call.

If, however, the price paid to purchase control of the company is in the form of shares of the acquirer, then the convertible may remain outstanding with the holder having the right to convert into the acquirer's shares. The new conversion rate would be determined by multiplying the conversion rate times the number of shares offered per share of the issuer by the acquirer. This is often an attractive outcome. All of the rights and entitlements of the investor are clearly stated in the issue's indenture.

Unfavorable Tax Treatment

Most convertible issues come in the form of bonds which makes interest paid to the holder a significant portion of the total return. Further, there are a few convertible issues that qualify as contingent payment debt instruments that may have phantom income (income not received but still taxed). Obviously in accounts that are not tax advantaged there will be tax consequences that must be understood, as this return is likely to be taxed at a higher rate than capital gains or qualified dividends. For accounts that are tax advantaged, such as most pension plans and IRA-type plans these tax considerations may not be consequential (please see a tax expert for actual treatment).

Summary

It is our contention that a portfolio of convertible securities can provide a total return over a full market cycle comparable to the return provided by equities, but with less volatility and higher current income. Not only have their absolute returns been higher than that of their underlying stock returns, their risk adjusted returns have been substantially higher than equity valuation models such as the Capital Asset Pricing Model (CAPM) would imply. The unique convertible structure offers much of the best of both the fixed income and equity worlds, although it is often overlooked by investors. In examining the returns generated by a broad convertible index, the Bank of America Merrill Lynch All Convertibles Index (VXA0) has outperformed the S&P 500 for the 3, 5 and 10 year periods ending 9/30/2011 with lower volatility. While past performance is no guarantee of future results, we believe that convertibles merit consideration as an appropriate asset class for many investors.

Who We Are

Dinsmore Capital Management (DCM), formerly Davis-Dinsmore Management, was founded in 1971 by Ronald Dinsmore. DCM is a privately held registered investment adviser specializing in convertible securities. Mr. Dinsmore was a pioneer in the closed-end fund business before passing away in 1996. His children, Thomas Dinsmore and Jane O’Keeffe have run the firm since 1994. The firm currently manages two closed-end funds, Bancroft Fund Ltd. (Ticker: BCV) and Ellsworth Fund Ltd. (Ticker: ECF), with assets under management as of 9/30/2011 of \$199 million. DCM is one of the longest running convertible securities money management firms in existence. The current management and its team of analysts, traders and support staff have been together for almost twenty years. Dinsmore Capital Management (DCM) has been certified a Women’s Business Enterprise (WBE) under the Minority and Women Certification Program of the State of New Jersey where DCM is located. The Department of the Treasury’s Division of Minority and Women Business Development of the State of New Jersey issued the certification. DCM is GIPS compliant verified by Ashland Partners LLP (1998-3Q11).

Thomas H. Dinsmore, CFA – Chairman/CEO of Dinsmore Capital Management. CEO/Portfolio Manager of Bancroft Fund Ltd.; CEO/Portfolio Manager of Ellsworth Fund Ltd. Before joining DCM in 1983 Tom worked at Morgan Stanley, Prudential Insurance Company and BASF. Tom is a Chartered Financial Analyst and has a BS in Economics from the Wharton School of Business, and an MA in Economics from Fairleigh Dickinson University where he was elected to Delta Mu Delta National Honor Society. He also participates in the CFA Institute continuing education program. Tom is a former President of the Closed-End Fund Association (CEFA), the national trade association representing the closed-end fund industry. He is also a member of the Investment Company Institute Closed-End Fund Subcommittee. Memberships include the CFA Institute and the NY Society of Security Analysts.

Jane D. O’Keeffe - President and Director of Dinsmore Capital Management and of Bancroft Fund Ltd. and Ellsworth Fund Ltd.. Jane has been in the investment business since 1980. She began as an assistant to the portfolio manager of IDS Progressive Fund. From 1983 through March 1986, she had research and portfolio management responsibilities at Soros Fund Management Company, In 1986, Jane was a portfolio manager and research analyst at Simms Capital Management until joining Fiduciary Trust International in 1988 where she became a Vice President and Portfolio Manager for individuals, endowments and foundations. Jane joined DCM in 1994. Jane has a BA from the University of New Hampshire and attended the Lubin Graduate School of Business at Pace University.

James Dinsmore, CFA - Vice President, Director and Assistant Portfolio Manager for Dinsmore Capital Management. Vice President of the Funds. He joined DCM in June 2004. Mr. Dinsmore is a CFA charterholder. He earned his MBA in finance and marketing from Rutgers University where he became a member of the Beta Gamma Sigma International Honor Society. James has a BA in Economics from Cornell University. Memberships include the CFA Institute and the NY Society of Security Analysts.

Peter M. Finnican – Peter joined Dinsmore Capital Management in 2007. He was a Principal at Morgan Stanley in the Convertible Group for 8 years and was most recently a Managing Director in the UBS Convertible Group for 7 years; in sales and management functions. He has a BA and MA from Manhattanville College.

If you have any comments on this paper or wish to know more about convertible securities, please feel free to contact us on our website www.dinsmorecap.com. We can also be reached at our offices at 65 Madison Avenue Suite 550, Morristown, NJ and our phone number is 973-631-1177.