

RELUCTANT CONVERTS

Convertible zero-coupon municipal bonds may offer the worst of both worlds.

BY EDWARD BROWN

There's a very attractive idea hovering around today's municipal bond market: Take an ordinary bond with a 30-year maturity and split it into parts. During the first years, investors receive a yield slightly below the market in a zero-coupon arrangement, where the bond is sold at a discount and gradually rises to face value. During the latter years, the yield increases—often dramatically. Thus, instead of paying 7 $\frac{1}{2}$ % to maturity, a zero-coupon issue yields 7 $\frac{1}{4}$ % for the first 12 years.

But rather than becoming redeemable after 12 years, the convertible bond simply begins trading at its face value, converting to an instrument in every way like a conventional bond. For the remaining 18 years, the bond pays as much as 10% a year. As with other municipal bonds, the interest—regardless of the form in which it is received—is not subject to federal taxes.

Based on numbers like these, the so-called convertible zero-coupon bond appears to be the best choice an investor can make in today's municipal bond market. With such cute marketing acronyms as LIMOs, COZYs, GAINs or STARs, they have begun to capture a small but increasing share of bond sales. For investors who want to avoid reinvesting during a period of falling interest rates but don't want to give up income entirely, this looks like the best of all worlds.

Planners who look closer, however, will find some interesting problems. The first and most obvious is the quality of the bonds themselves. Most convertible zeros on today's market carry a rating below AAA; indeed, many are unrated. Why? During the current shortage of municipal paper, AAA-rated bonds don't need bells and

whistles to make them attractive.

Of course, investors have to weigh security against yield when making any bond purchase. But with bonds that pay no income for a decade or more, credit quality takes on a magnified importance. After all, it is easy for municipal governments to issue debt obligations that won't cost them anything out of pocket for the foreseeable future and perhaps even for the remainder of their term in municipal office. Any debt collector knows that a questionable credit risk becomes much more dangerous if the debtor is spared from making payments for the first 10 years of his loan obligation.

A second, more complicated problem with convertible zeros is the call provisions written into their contracts. Conventional bonds usually can be called at par or above, and since par is the maturity value, the buyer faces little risk of a loss. A call provision at par for conventional bonds will simply keep the paper from trading at too much of a premium.

With convertible zeros, however, the issue price is considered par for the purposes of the call provision. Many investors buy their municipal bonds in the secondary market—after, in the case of a zero-coupon issue, some of the interest has accrued and driven up the trading price of the bond. Suppose, for example, a 30-year convertible zero is issued at 40, and a financial planning client purchases the bond two years later at 45, with the full maturity price of 100 still eight or 10 years away. If the bond is called at par during the accruing period, then he would receive no income and would have to redeem the bond for \$5 less than he paid for it.

A number of zero-coupon issues do require 10 years or more to elapse

before the call provision can be exercised. However, there are a number of exceptions. "The buyer must be especially careful of housing bonds because they are callable at any interest date," says Wayne Culver of Smith Culver Inc. in Larkspur, California. Investors learned firsthand how important these call dates can be when, in October 1988, a Puerto Rican housing bond was called at par just three years after issuance. The prospectus contained a provision that if the funds were not expended within three years, "an unexpended funds call" would occur. Most investors purchased the bonds at 48 or higher; when the bonds were called at par—45—they found themselves with three years of no income and a three-point capital loss.

Even if the bond is not called, the threat of such a catastrophe can hang like a sword of Damocles over an investor's head, depressing the bond's price for years in the secondary market. Then after the initial danger is over and the bond reaches par and begins paying out 10% or more in some cases, the call provision may allow the issuer to redeem at face value and take away the attractive yield for something a little closer to market.

In that situation, the investor at least avoids a capital loss. But he may have held unrated paper and collected a lower-than-market yield for a decade or more only to be sent back his money without so much as a handshake. The only solution to the dilemma is for financial advisers to read the prospectus carefully and determine when and under what circumstances a bond can be called.

"All these things—the credit quality, the call provisions—are usually factored into the price of the bond to begin with," says Rhonda Bennett, an editor with *The Bond Buyer* in New York. "But with something this new or this complicated, you may not have the same efficient, knowledgeable market that you might have for more conventional issues. There's a chance that you may not be fully compensated for the risk you are taking." In other words, the new hybrid convertible zero has not yet found an efficient market, and the odds—for now at least—rest with the issuer. □