Q65

With reference to Convertible Bonds, consider the following statements: 1. As there is an option to exchange the bond for equity, Convertible Bonds pay a lower rate of interest. 2. The option to convert to equity affords the bondholder a degree of indexation to rising consumer prices. Which of the statements given above is/are correct? (a) 1 only (b) 2 only (c) Both 1 and 2 (d) Neither 1 nor 2 Official key: C.

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Explanation

(a)

1 only. The equity kicker is also a partial inflation hedge, so 2 holds.

(b)

2 only. Convertibles do pay a lower coupon because of the option.

(c) Official key

Both. Lower coupon for the conversion option; equity upside indexes the holder to rising prices in part.

(d)

Neither. Both are standard convertibles lore.

Summary

Official key is (c) both. A convertible pays a lower yield because the holder owns a call on equity. That equity link gives some indexation if consumer prices and share prices rise together.

Related possible facts

These can be asked in a future Prelims paper.

Convertible bond
Debt plus an option to convert into shares.

Conversion premium
How far the share must rally before conversion pays.