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Faithful to Convertibles

Andrew Davis and Jason Voss of Davis Appreciation & Income Fund discuss their strategy for riding market upswings and avoiding falls

For Andrew Davis and Jason Voss, blending convertible bonds with common stocks and bonds is a recipe for appetizing returns. The co-managers of the Davis Appreciation & Income Fund/A (RPFCX) seek to participate in market upswings while avoiding some of the downside. To do so, they purchase securities in mixtures that will capture 80% of the market's rise while reducing the risk of any decline by half.

This strategy, which they call the 80/50 rule, has earned the fund a 4-Star ranking from Standard & Poor's (5 Stars is the highest rank). For the one-year period ended Feb. 28, the fund gained 8.8%, vs. 3.6% for its peers and 7% for the S&P 500-stock index. For the three- and five-year periods, it rose 11.9% and 4.4%, respectively, vs. 8.6% and 1.7% for its peers, and a 4.6% and 1% decline for the S&P 500.

DODGING THE TECH BUST. While Standard & Poor's categorizes the portfolio as a domestic taxable fixed-income fund based on its holdings, Davis Appreciation & Income has an equity orientation. "We think of this fund as being an equity-like product, and that's how we manage it," says Voss. Accordingly, the fund managers have selected the S&P 500 as their performance benchmark.

Reflecting the fund's conservative bent, the portfolio has a low standard deviation relative to its peers. Tellingly, during the technology bust years of 2000, 2001, and 2002, it lost 1%, 7.6%, and 1.2%, respectively, while the S&P 500 fell 9.1%, 11.9%, and 22.9%. According to Standard & Poor's holdings data, the portfolio had 54.19% in U.S. convertibles as of Sept. 30, 2004.

The fund follows the investment philosophy of other Davis family funds, described on the firm's Web site as the "Davis research methodology." However, the 80/50 rule distinguishes this fund from its brethren. By prospectus, it may hold common stocks of small-, mid-, and large-cap companies; investment-grade and high-yield bonds; preferred stock; and convertibles.

THINK LIKE OWNERS. "We're looking for businesses that are extraordinarily well run by talented folks," Voss says. "Those businesses have what we like to call moats around them, meaning that their business model is sustainable over long periods of time and will do well during various economic cycles."

After identifying such businesses trading at reasonable prices, the co-managers consider the instruments available -- be they convertible bonds, preferred stock, or a stock-and-bond combination. Davis explains that the latter mixture "mimics" convertible bonds, with stock providing an 80% potential upside and bonds offering the expected 50% protection.

Of the other factors the co-managers consider, the most important is "owner earnings yield." This ratio, a form of adjusted earnings defined as excess cash earnings over enterprise value, lets them compare the attractiveness of investments with the risk-free rate. "We do not focus on earnings per share or free cash flow," Davis says. "We try to imagine as if we owned the entire business" -- that is, how much cash would be left over after investing enough to keep the business competitive. Other considerations: degree of insider ownership, reinvestment of capital, transparent and consistent financial reporting, and level of off-balance-sheet liabilities.

SIZING UP RISK. As of Dec. 31, 2004, the fund's five largest sectors represented less than 50% of assets. They included real estate (20.4%), financial services (12.3%), electronics (6%), energy (5.4%), and environmental, waste, and cleaning services (4.6%).

Among its 46 holdings, the five largest were SL Green Realty (SLG); Lehman Brothers Holdings, Conv. Notes, 0.25%, 82/3/11 144A convertible into Devon Energy (DVN); American Express (AXP), Conv. Notes, 1.85%, 12/1/33 144A; Waste Connections (WCN) Conv. Sub. Notes Floater, 2.66%, 5/1/22; and Vornado Realty Trust (VNO). The fund holds some real estate common stocks without the offsetting bonds. These stocks are similar to convertible bonds in their risk characteristics and yield orientation, Davis notes.

Asked how he manages risk within the fund, Voss quoted a former business school professor who advised: "Watch everything."

SIX FLAGS ANOMALY. Davis adds: "The principal way we manage risk is by having a thorough underwriting process whereby we talk to management, look at the business, [and see] how it has performed over five years." In addition, the fund cannot put more than 5% of assets in any single company.

Once the co-managers do buy securities, they rarely sell. And they generally don't convert them to stock unless the bonds are called by the issuer. Davis observed that they are more likely to "add and trim" -- rather than buy and sell -- in order to satisfy the 80/50 rule. As of Feb. 28, 2005, the fund's 33.4% turnover rate includes forced conversions. "It's probably been four years since we've sold out of a position entirely," Voss notes, recalling the fund's exit from its Six Flags (PKS) holdings in 2001 and 2002.

The fund avoids convertibles that don't fit into the 80/50 rule, which usually means those with big premiums. Voss says they tend to stay away from "ugly" businesses, such as airlines and steel companies, while favoring financial services, power, real estate, and some areas of technology. The co-managers don't shy away from companies whose shares are trading below intrinsic value, but they don't purchase distressed debt intending to turn around (or liquidate) a failing company. "We will not buy something simply because it's dirt cheap," Davis says. "That kind of investing can get you in a lot of trouble."