

Convertible Bond Primer

The first U.S. convertible bond is thought to have been issued in the second half of the 1800s for the purposes of financing a railroad project. At that time, the U.S. was a young emerging economy with undeveloped capital markets. The convertibility clause was added to bonds to entice what was then a relatively small pool of prospective investors. More than 100 years later as of the end of 2010, the outstanding convertible bond market in the U.S. had grown to more than \$200 billion.¹

A convertible bond is a traditional corporate bond with the additional feature of being convertible, at the investor's discretion, into a pre-determined number of shares of common stock. As such, convertibles are hybrid securities that combine both equity and debt characteristics. Through the equity characteristic, investors in convertible securities have the potential to participate in appreciation of the underlying stock, while the debt characteristic offers the potential for a more limited downside than equities.

A convertible bond's debt characteristic means that its price is a function of interest rates and the credit worthiness of the issuer. An investor's ability to choose to hold a convertible bond to maturity and redeem it at par offers a measure of protection from a decline in the price of the equity. The equity feature of a convertible bond is derived through an embedded call option that enables the bond to participate in appreciation of the underlying equity.

Convertible Basics

Factors that impact a company's stock price need not necessarily impact its credit worthiness. In other words, a decline in a company's equity value doesn't necessarily mean it is any less able to repay its bond holders.

A stock has unlimited upside potential, while a bond is always moving closer to its maturity, the day when it is scheduled to be redeemed at its par value.

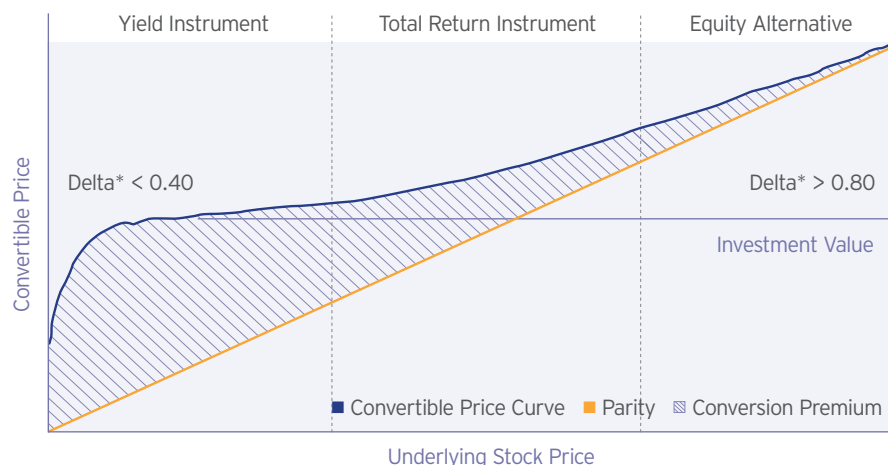
A Bond-Stock Crossbreed

The nature of a convertible bond allows it to be influenced in different ways by different markets at different times. The two primary determinants of a convertible's behavior are its yield and its conversion premium. Yield is a function of a bond's coupon, maturity and price. Conversion premium is a function of the price of the bond relative to the current value of the stock into which it can be converted.

Formally, the conversion premium is the amount by which the convertible bond's price exceeds its conversion value, expressed as a percentage. For example, suppose a bond, convertible into 100 shares of stock, has a price of \$1,000. If the stock were trading at \$8 per share, the bond would have a conversion premium of 25%: $(\$1,000 - \$800) \div 800 = 0.25$.

The yield and conversion premium levels on a convertible bond will correlate with whether it acts more like a stock or a bond. The chart below displays the relationship between these factors and a convertible's behavior:

Convertible Price Curve¹



*Delta is a measure of the sensitivity of a bond's price to movements in its underlying stock. For illustrative purposes only.

Investments in convertible securities are subject to the risks associated with both fixed-income securities, including credit risk and interest rate risk, and common stocks. Convertible securities may have lower yields because they offer the opportunity to be converted into stock and if the stock is underperforming and the bond does not convert then the bond may have a lower return than a non-convertible bond.

View the last page of this document for definitions of terms and indices.

Yield instruments: When the value of a convertible bond's underlying stock is far below the price of the bond, the bond will exhibit little sensitivity to the stock and behave more like a pure debt instrument. A convertible in this category (left side of the chart) will generally display yields and conversion premiums that are higher than those of convertibles in the other two categories.

Total return instruments: A convertible bond in this range looks most like a hybrid, exhibiting a relatively balanced blend of both equity and debt characteristics. Moderate yields and conversion premiums combined with a fair amount of equity sensitivity may make convertibles in this category (middle of the chart) relatively attractive to investors seeking total return.

Equity Alternative: When the value of a convertible bond's underlying stock is near or at the price of the bond, the bond will behave more like the stock. In doing so, it will generally exhibit lower yields and conversion premiums (right side of the chart).

Reasons for Investing in Convertibles

By combining the characteristics of debt and equity, convertible bonds may offer the following potential advantages over straight debt and equity:

- Yield advantage over equities
- Participation in equity upside, with a par value anchor
- Improved risk profile relative to equities
- Broader investment opportunities

Yield Advantage Over Equities

As indicated in the chart below, since 1995, convertibles (represented by the BofA Merrill Lynch All U.S. Convertibles IndexSM) have offered a current yield (coupon ÷ price) that has, on average, been 216 basis points more than the trailing 12-month dividend yield of equities (represented by the S&P 500 Index):

Yield Comparison



Source: Bloomberg L.P., as of May 31, 2011. Past performance is no guarantee of future results. An investor cannot invest directly in an index.

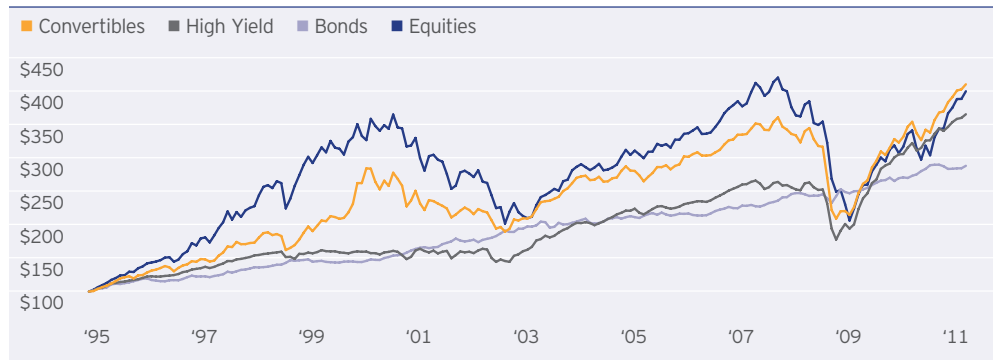
Participation in Equity Upside, with a Par-value Anchor

The convertibility feature of a convertible bond offers the ability to participate in upward price movement of the underlying stock, while the par value of a convertible bond has the potential to act as an anchor in a downward stock market as it trades increasingly more like a straight bond. Additionally, if the issuer goes bankrupt, convertibles rank higher in the capital structure than common stock.

Aside from their market value, convertible bonds also maintain what is referred to as an investment value. A convertible's investment value is its value as a straight bond without consideration of the conversion feature (represented as the straight flat line in the **Convertible Price Curve chart** on the previous page). When a convertible bond exhibits a low level of equity sensitivity, it should trade at or near its investment value in the absence of any adverse changes in interest rates or credit quality.

A convertible's par-value anchor means that the price of the convertible will normally not rise as quickly as the common stock in a very bullish environment. Its convertibility also means that it generally won't be quite as defensive as a straight bond in a declining equity market. These traits notwithstanding, over longer periods convertibles have exhibited attractive performance relative to both stocks and bonds, as indicated in the chart on the next page.

Index Performance



Source: Bloomberg L.P., as of May 31, 2011.

An examination of the 186 rolling 12-month periods from January 1995 through May 2011 shows that equities had negative performance during 51 of them. During those periods, convertible bonds outperformed equities by an average of 7.6%, participating on average* in only 61% of its downside.

Conversely, in the 135 periods of positive S&P 500 performance, it outperformed convertibles by an average of 2.1%, with convertibles participating on average in 83% of the upside.¹

Peak to Trough of S&P 500 Index	Convertibles	Equities
Sept. 1, 2000 - Oct. 9, 2002	-35.1%	-47.4%
Oct. 9, 2007 - March 9, 2009	-42.8%	-55.3%

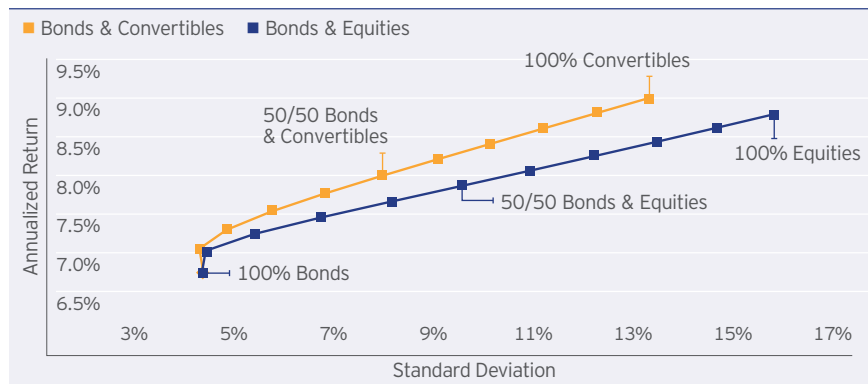
Source: Bloomberg L.P.

Improved Risk Profile

As noted above, it has generally been during down equity markets that convertibles have accumulated their longer term outperformance. However, less downside participation is not the only way that convertibles may help to improve a portfolio's risk profile. Their historically low correlation to other segments of the fixed-income market may provide a diversification benefit that may help to reduce the volatility of a traditional stock and bond portfolio without sacrificing returns.

From 1995 through May 2011, convertibles exhibited a correlation of 0.07 with investment-grade bonds, as represented by the BofA Merrill Lynch U.S. Corporate & Government Master Index. As indicated in the efficient frontier chart below, a portfolio of bonds and convertibles offered both higher returns and lower volatility than a portfolio of bonds and stocks:

Efficient Frontier (January 1995 - May 2011)



Source: Bloomberg L.P., as of May 31, 2011. Past performance is no guarantee of future results. An investor cannot invest directly in an index.

*To calculate downside and upside participation, a harmonic average was used, which is a method of calculating an average that lessens the impact of large outliers and increases the impact of small ones.

1 Source: Bloomberg L.P., as of May 31, 2011

Past performance is no guarantee of future results. An investor cannot invest directly in an index. Bonds are represented by the BofA Merrill Lynch U.S. Corporate & Government Master Index. High-yield bonds are represented by the BofA Merrill Lynch U.S. High Yield Master II Index. Convertibles are represented by the BofA Merrill Lynch All U.S. Convertibles Index. Equities are represented by the S&P 500, which is an unmanaged index considered representative of the U.S. stock market.

Broader Investment Opportunities

The various structures and investment characteristics (yield, delta, conversion premium, etc.) of convertible bonds enable them to be used by investors to meet varying investment objectives. Bond investors facing constraints in their ability to add pure equity exposure may be able to derive exposure through convertibles.

On the other hand, equity investors may be able to increase their yield by adding convertibles to their portfolio. Also, equity investors with a lower risk tolerance might consider convertibles as a means of maintaining a more defensive equity position. Given their long-term performance and risk/reward profile relative to equities, convertibles may be a sensible addition to the core of investors' portfolios.

BofA Merrill Lynch U.S. High Yield Master II Index is an unmanaged index considered representative of the market for high yield bonds. BofA Merrill Lynch All U.S. Convertibles Index (VXAO) is an unmanaged index considered representative of the convertible market. BofA Merrill Lynch U.S. Corporate & Government Master Index (BOAO) is an unmanaged index considered representative of the market for government and investment-grade corporate bonds.

Volatility is the annualized standard deviation of returns.

Delta is a measure of the sensitivity of a bond's price to movements in its underlying stock.

The value of convertible securities tends to vary with fluctuations in the market value of the underlying securities. Convertible securities are subject to the risk of default by the issuer.

Fixed-income securities such as convertible bonds carry interest rate and credit risk. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. Credit risk is the risk of loss on an investment due to the deterioration of an issuer's financial health.

Convertible bonds may be subject to call risk, which may result in the Fund having to reinvest the proceeds at lower interest rates, resulting in a decline in the Fund's income. Non-investment grade securities have additional risks, including higher default risk and decreased market liquidity.

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