




Investment Viewpoints

Bank of America and Equity Income: Convertible Securities in Action

By Matt Oldroyd, Vice President, Client Portfolio Manager



In its quest to provide attractive, risk-adjusted performance, the American Century Equity Income portfolio uses convertible securities to dampen the volatility of its returns, help limit downside risk, and enhance yield. Since its 1994 inception, the portfolio has historically held convertibles comprising 15% to 30% of assets; currently, approximately 18% of Equity Income's assets are divided between convertible bonds and convertible preferred stocks. Through the review of a current holding, we can examine the Equity Income team's convertibles philosophy and the central role these securities play in the portfolio.

The Investment: Convertible Preferred Stock from Bank of America Corp.

One of Equity Income's significant holdings—the portfolio's third largest position as of June 30, 2008, representing almost 5% of the portfolio—is a convertible preferred stock issued by Bank of America Corp. The Charlotte, N.C.-based company is the nation's largest consumer bank, with a market share of national deposits of about 10%. At the start of 2008, Bank of America had almost \$1.7 trillion in assets, with 54 million consumer and small business relationships.

The Equity Income team participated in Bank of America's offering of convertible preferred shares on January 28, 2008, the day the bank announced it was issuing \$6.9 billion of convertible stock. The shares have a dividend income rate of 7.25%.

At the time, Bank of America's common stock was selling for \$41.20, down from a high of \$52.71 during the fall of 2007. The bank's profits were declining in the face of rising loan losses and mortgage-related write-downs. Bank of America relies on consumer lending for a significant portion of its earnings, and borrowers, beset by declining real incomes and home prices, have been contributing to deteriorating credit metrics.

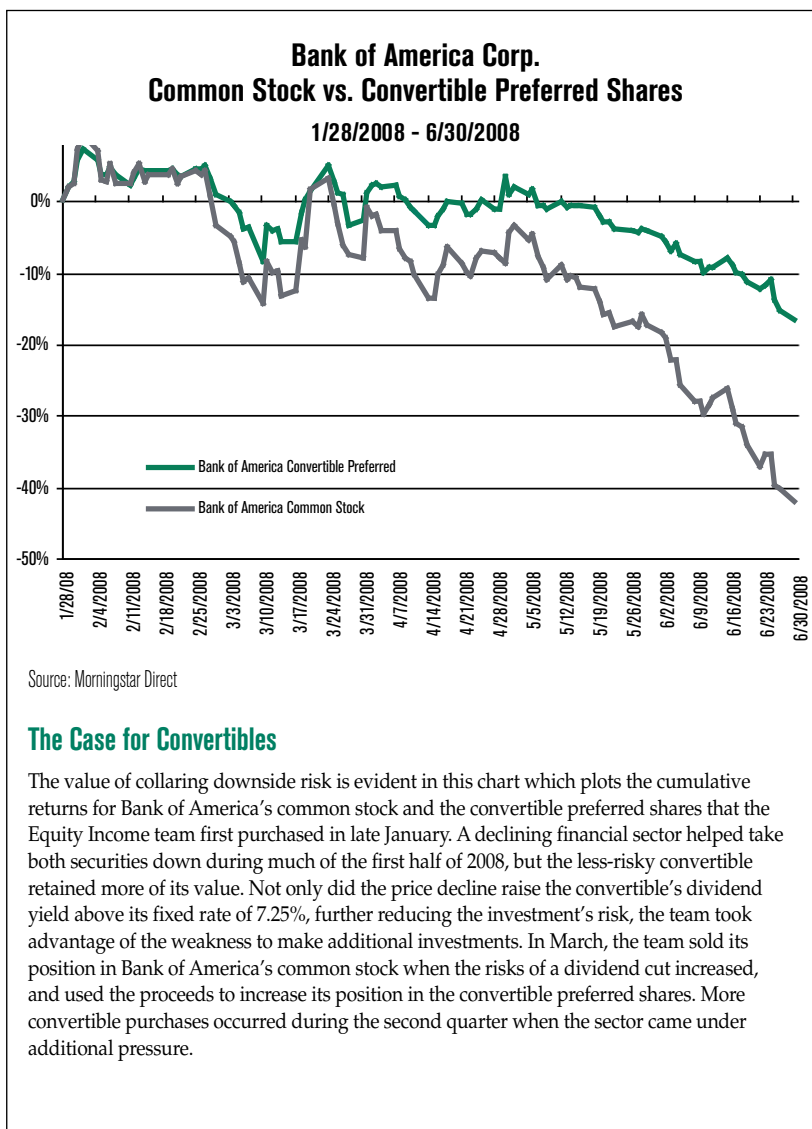
“Essentially, the convertible preferred provides us with bond-like benefits in a down market, but stock-like returns in a market rally.”

— Chief Investment Officer, U.S. Value Equity, Phillip Davidson

Like most financial services companies, the bank had been struggling for several months in the fallout from the credit crunch spurred by the nation's mortgage crisis. Upon further fundamental analysis, the investment team identified Bank of America as a higher-quality bank within the industry that was in a position to ride out the current credit-market conditions. “Bank of America has a strong franchise with well-diversified funding streams,” says Chief Investment Officer, U.S. Value Equity, Phillip Davidson. “Although the bank has and will continue to suffer some mortgage-related losses, those losses are manageable in our opinion, and haven't put too much of a constraint on the bank's capital relative to some of its competitors. I think we've come to a point in the financial industry's travails where the strong are going to get stronger. Bank of America should be a market share gainer as rivals with more impaired balance sheets have to pull back.”

Convertibles Collar Downside Risk

The investment team's preference for the convertible securities was in line with the risk-averse strategy that has guided Equity Income for the past 13 years. "To use a football analogy, if you're going to invest in financials, this is a time when the best offense may be a good defense," says Davidson. "The convertible's 7.25% dividend yield helped collar our downside risk, while we retained the ability to participate if the shares moved up over time. Essentially, the convertible preferred provides us with bond-like benefits in a down market, but stock-like returns in a market rally."



Convertibles Defined

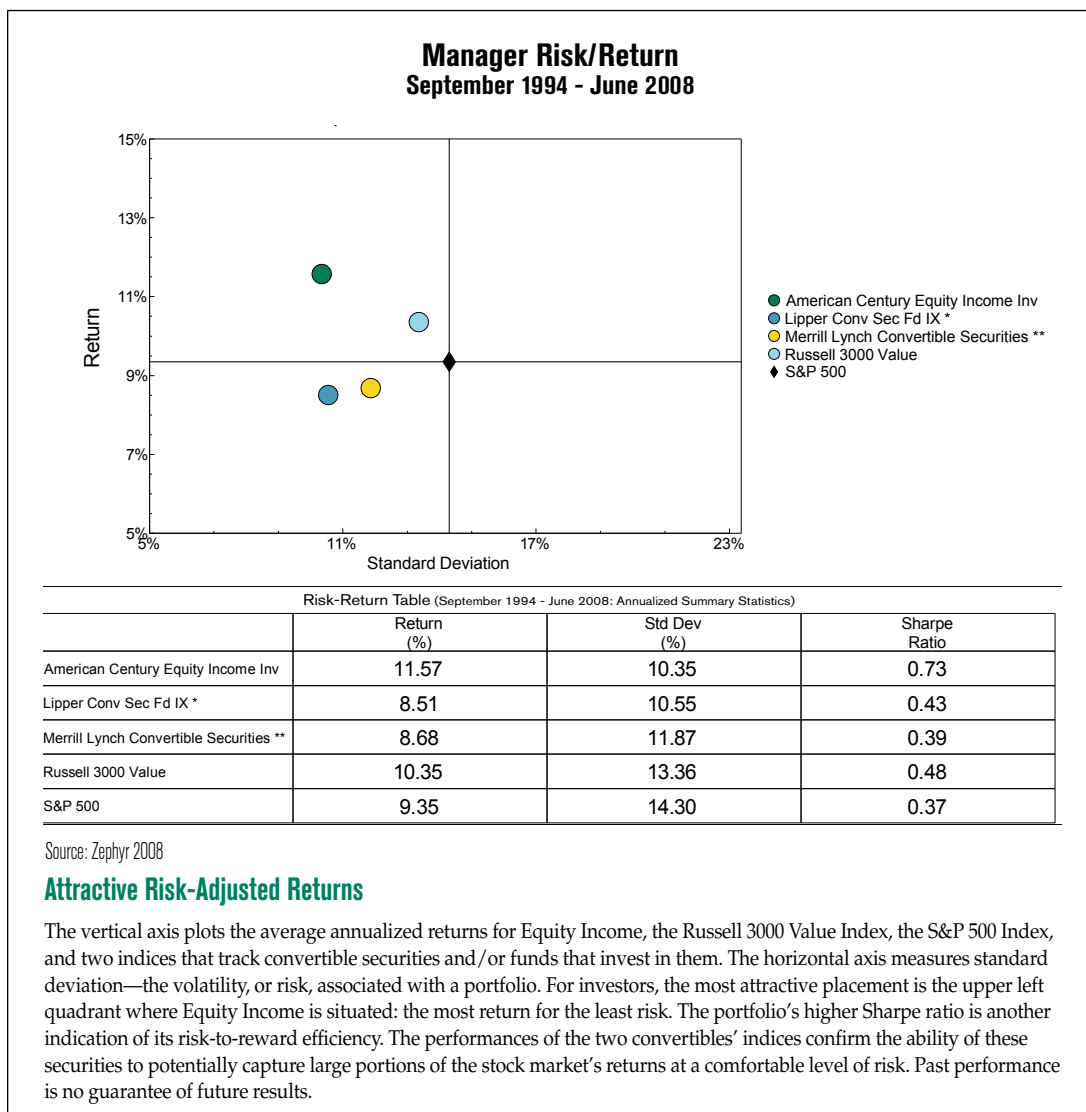
As the name implies, **convertible** securities can be converted at the investor's choice into other investments, normally into shares of the issuer's underlying common stock. Convertibles are typically issued as bonds or preferred stock. **Convertible bonds**, which provide an ongoing stream of income, can be converted into a preset number of shares of the company's common stock. Unlike common stock, which pays a variable dividend depending on a corporation's earnings, **convertible preferred stock** pays a fixed quarterly dividend. It can be converted into common stock at any time.

Combining the Best Features of Bonds and Stocks

Although they are equity securities, convertible preferred shares combine the characteristics of bonds and stocks, providing attractive dividend rates that reduce downside risk, along with the potential for capital appreciation. That's clear in the chart (page 3) for Bank of America's convertible preferred. During the five-month period from late January through June 30, the bank's common stock fell 39.9%, a decline that actually was in line with the 38% drop for average bank in the S&P Bank Index, which tracks the 18 banks in the broad-market S&P 500 Index. Yet during the same period, the convertible preferred declined 13.5%, capturing only one-third of the common's loss. Next, note the two securities' brief move to the upside in March. From March 10 through March 24, financials rallied as the Federal Reserve facilitated JPMorgan Chase's acquisition of beleaguered Bear Stearns. Bank of America's common stock gained 20.2% during just eleven trading days. Meanwhile, the bank's convertible preferred advanced 14.6%, or almost 75% of the common stock's rise.

Convertibles: A Main Ingredient in Risk-Adjusted Returns

This Manager Risk/Return chart measures the life-of-portfolio performance for Equity Income relative to risk. The chart also underscores the performance-protection relationship inherent in convertible securities.





Quality Convertibles Can Provide Protection and Performance

While convertibles as a class have provided good returns over time, not all convertibles are created equal. Historically, the best convertibles have been those tied to higher-quality companies whose common stock has the potential to move higher over time. “Our investment in Bank of America’s convertible preferred is a good illustration of our ‘belt and suspenders’ approach to controlling absolute risk,” says Davidson. “If we own the ‘best-of-the-best’ convertibles, we’re in a position to provide our investors with downside protection as we seek solid returns over time.”

August 2008

*The Lipper Convertible Securities Fund Index is an unmanaged index of the 10 largest funds in the Lipper Convertible Securities fund category, which consists of funds that invest primarily in convertible bonds and convertible preferred stock.

**The Merrill Lynch (ML) All Convertible Securities Index is an unmanaged market-capitalization-weighted index of domestic corporate convertible securities. To be included in the index, bonds and preferred stock must be convertible only to common stock and have a market value or original par value of at least \$50 million.

The opinions expressed are those of Phillip Davidson and are no guarantee of the future performance of any American Century portfolio. Statements regarding specific holdings represent personal views and compensation has not been received in connection with such views.

Before investing, carefully consider the fund's investment objectives, charges and expenses. Contact 1-800-345-6488 for a prospectus containing this and other information. Read it carefully.



American Century
Investments®

P.O. Box 419385
Kansas City, MO 64141-6385
1-800-345-6488
www.americancentury.com/ipro

American Century Investment Services, Inc., Distributor

©2008 American Century Proprietary Holdings Inc. All rights reserved.

IM-FLY-61750 0808

FOR INSTITUTIONAL USE ONLY/NOT FOR PUBLIC USE