Calamos Advisors LLC

# Convertible Market Outlook

CALAMOS®

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We believe there are excellent opportunities today to take advantage of the convertible market through outright long positions or arbitrage positions.

## How Attractive are Convertible Securities Today?

These days it is not uncommon for talking heads to comment in the media about how undervalued some stock, bond or commodity is. But not all undervaluations are equal, either in their accuracy or in their ability to help investors harness current opportunities. Common stock and bond valuation may suffer from a lack of transparency and emphasis on future expectations. Common stock valuation is almost entirely forward looking, based on future free cash flows and a company's ability to provide a competitive return on capital above its cost of capital. Bond valuation is also forward looking in regard to inflation and credit spreads, though it can offer higher confidence, in line with the credit quality of the issuer.

Convertible valuation is based on arbitrage theory and a neutral hedge argument, meaning that all or most risks of the security can by hedged or significantly reduced, resulting in a risk-free return on the security. If the hedged security offered returns above the risk-free rate, arbitrageurs will step in and purchase the security and drive the value up until the risk-free return is achieved. Likewise, if the hedged convertible offered a below-risk-free return, the arbitrageur would short the security and establish the reverse hedge. An economic convergence is very likely to occur unless some market dislocation takes precedence. Today, the massive deleveraging and liquidity squeeze has presented what we believe is a rare opportunity in the convertible marketplace.

Because it is more robust, we believe convertible valuation provides a much higher degree of reliability and different reversion to the mean value compared to stocks and bonds. Convertible valuation involves estimating the implied volatility of the underlying stock, as well as the credit quality and spread for the issuer. Multiple embedded options, call features, contingencies and triggers can make convertible terms complicated, but the finance and math models appear to handle most of this quite well.

What distinguishes convertible valuation is that an investor can arbitrage price inefficiencies by: shorting the underlying stock or a like corporate bond, purchasing credit insurance (a credit default swap) against the security, purchasing or selling options that match the embedded options in the security, as well as other creative means to arbitrage the security. The result is a highly correlated hedge with a high probability of economic convergence. In practice, if all risks are hedged, the return offered the investor is equivalent to the risk-free rate, so arbitrageurs accept a high degree of active risks with which they are comfortable, while hedging the highest risks. Often, hedging the convertible's equity sensitivity is the chosen route because of the degree of volatility in the equity, as compared to the other risks.

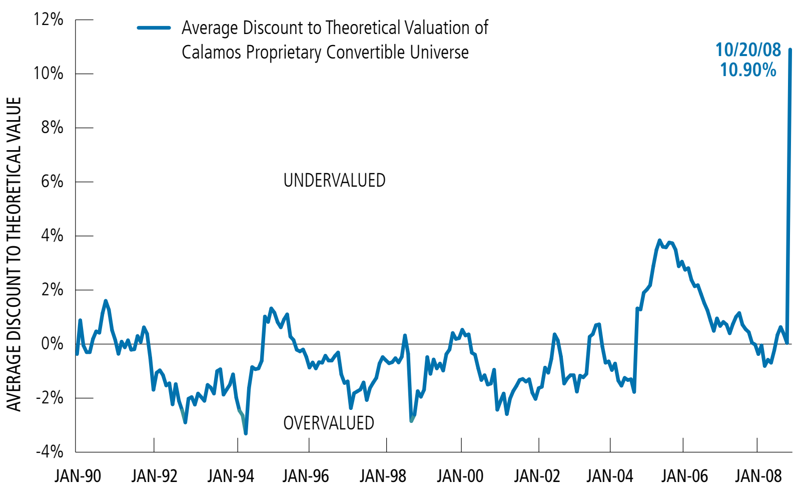
Of course, there are limitations to any valuation analysis. However, because of the economic convergence that will occur with the security's components and the hedge, convertibles therefore offer a more consistent mean reversion with a high degree of accuracy in the arbitrage. The popularity of the convertible hedge with hedge funds is due to its high correlation with other asset classes.

### Unprecedented Opportunity

The objective convertible valuation has been mean reverting over time. Figure 1 (next page) shows the mean convertible security valuation over the past 18 years, as measured by our proprietary valuation model. We have often published this chart, but today it

**Fig. 1: Calamos Estimated Undervaluation of the Convertible Market**

All U.S. Convertibles, January 31, 1990 to October 20, 2008




Source: Calamos Corporate System (CCS), Calamos Advisors LLC. 2008

tells a story we never thought was possible. As of October 20, 2008, the undervaluation of the convertible market is an historic 10.9%. This level of undervaluation represents what we believe is a very rare opportunity—one we have never witnessed in more than 30 years of managing convertible portfolios.

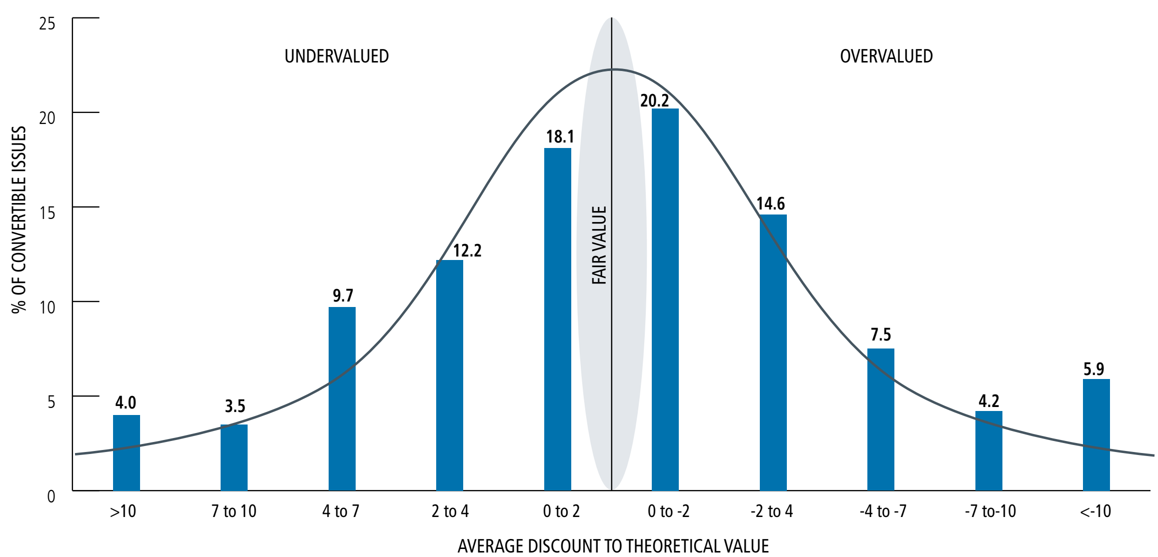
According to our analysis, the valuation distribution in the convertible market has shifted significantly over the past year and provides a further illustration of the extreme level of undervaluation (Figures 2a and 2b). The valuation distribution has moved from a close-to-a normal distribution around the mean, to a distribution heavily skewed to the left. A year ago, the mean was about 1% overvalued; more recently, the mean has been about -10%.

## Implied Volatility Analysis Signals Opportunity Potential

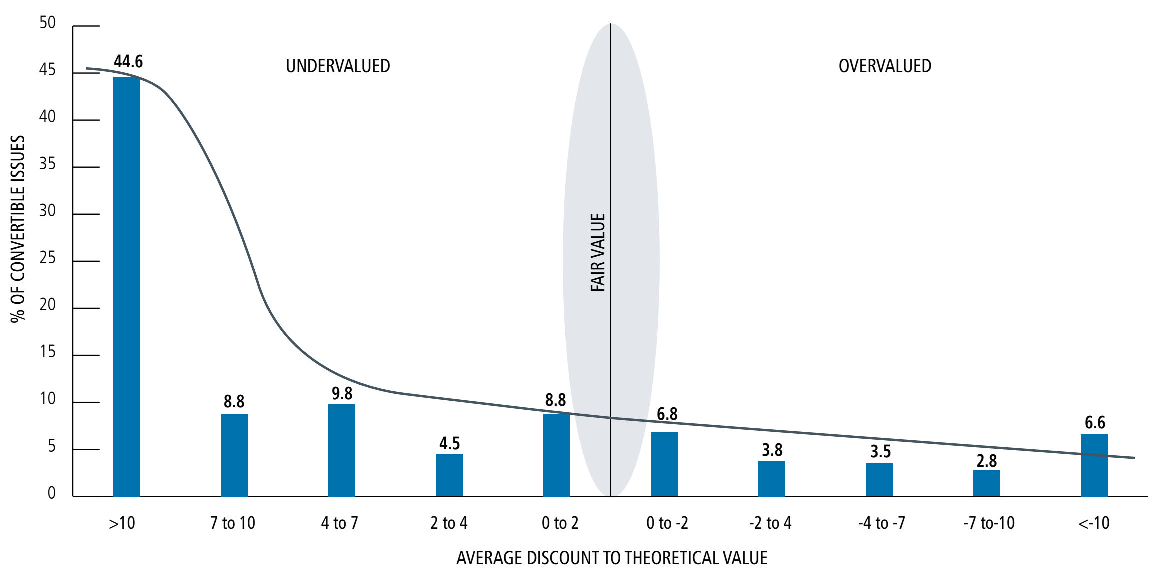
We believe another indication of the incredible opportunity in the marketplace can be found by comparing the implied volatility inherent in the convertible market with the implied

**Fig. 2: Calamos Estimated Convertible Market Valuation Distribution**

2a. Close-to-Normal Distribution: September 30, 2007




2b. Highly Unusual Skew: October 20, 2008

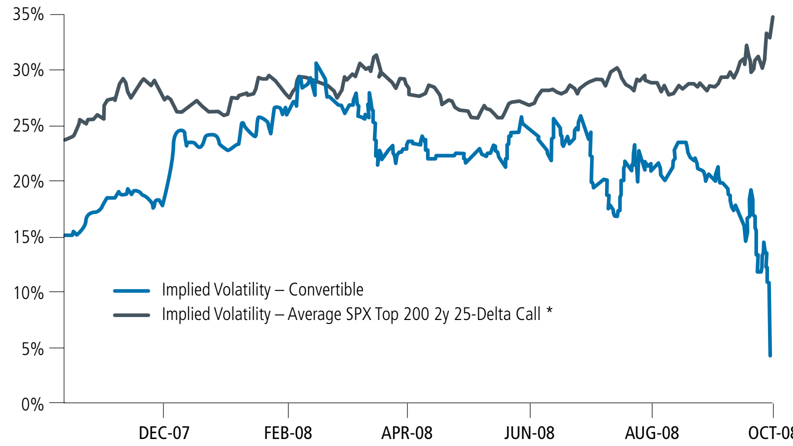



Source: Calamos Corporate System (CCS), Calamos Advisors LLC. 2008 volatility in the options marketplace for similar companies. Implied volatility measures investors' expectations of future volatility in the market, stock or asset under consideration. In today's market, option implied volatility has increased, causing option values to increase dramatically while the options embedded in convertibles have seen implied volatility collapse toward zero! (Fig. 3; data courtesy of Goldman Sachs Research.)

A convertible with an implied volatility of zero indicates the option embedded in the convertible is free. Of course, a free option does show up every now and then in the marketplace, but certainly not with the frequency that we see today. In the past, a convertible with a free option indicated the convertible was busted and traded only on its fixed-income value. This occurs when the equity price has declined considerably and investors don't expect any future value from the significantly out-of-the-money option.

**Fig. 3: Implied Volatility, Convertibles versus Options**

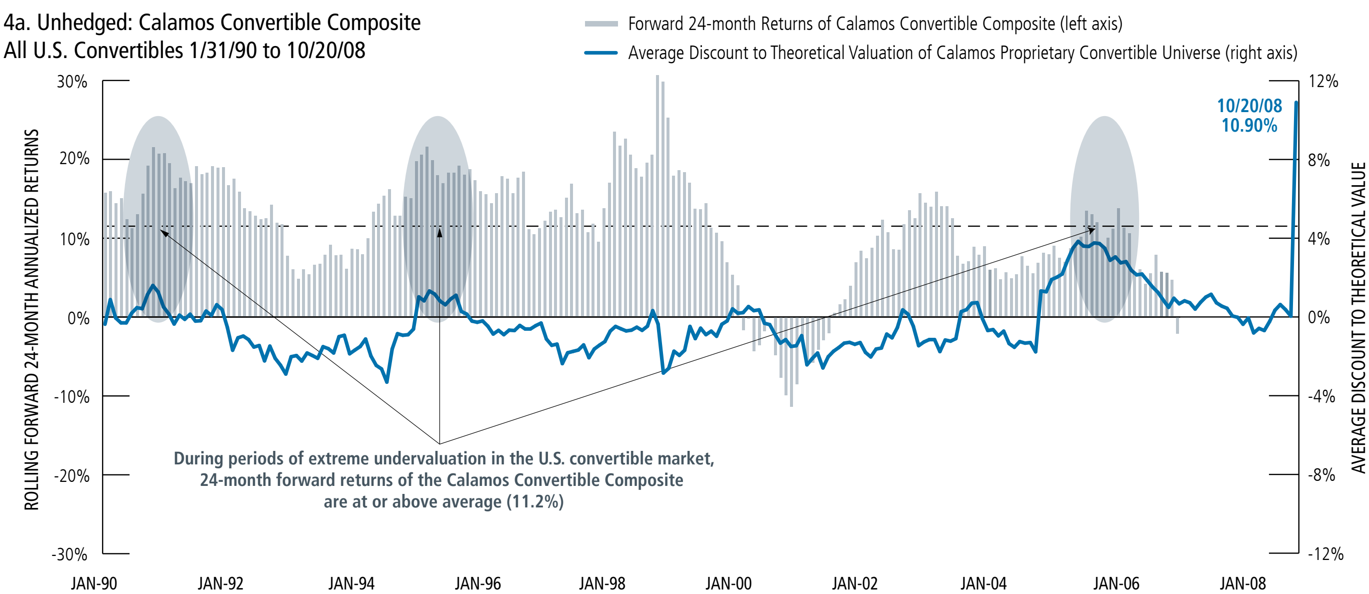
October 12, 2007 through October 1, 2008



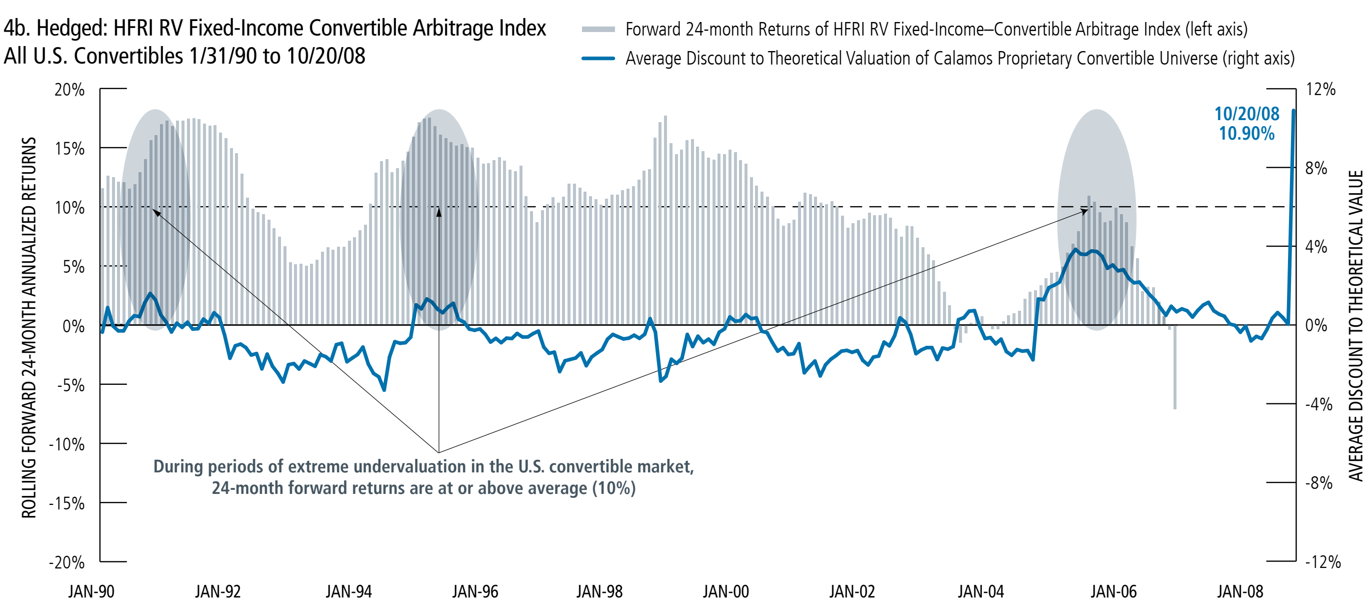

Source: Goldman Sachs "Opportunities in the Convertible Bond Market." October 10, 2008.
*An average of a subset of options for the largest 200 companies within the S&P 500 Index.

**Fig. 4. Historical Valuations and Performance of Unhedged and Hedged Convertible Portfolios**

4a. Unhedged: Calamos Convertible Composite
All U.S. Convertibles 1/31/90 to 10/20/08




4b. Hedged: HFRI RV Fixed-Income Convertible Arbitrage Index
All U.S. Convertibles 1/31/90 to 10/20/08




Source: Calamos Corporate System (CCS), Calamos Advisors LLC. 2008

Today, the valuation is different. In many cases, an investor can sell a similar option in the marketplace against the embedded convertible option and arbitrage the discrepancy. In normal markets, the option and convertible implied volatilities should be close; and on an individual security and option basis, they should be very close. The current options market indicates value in the same strike and maturity that the convertible market prices at zero. These opportunities are present today because of an unprecedented sell-off in convertible securities, as panicked hedge funds and investment banks have sought liquidity in the face of mounting margin calls.

## Capitalizing on Unusual Convertible Market Conditions

In this environment, we believe there are excellent opportunities today to take advantage of the convertible market through outright long positions or arbitrage positions. Figures 4a and 4b reveal how an undervalued convertible market has historically presented very good returns for the long (or hedged) investor.

From January 31, 1990 through October 20, 2008, there were three periods when the convertible market was extremely undervalued according to our analysis—in 1990, 1995, and in 2005. Figure 4a shows the rolling forward 24-month annualized returns of Calamos Convertible Composite (gross of fees), beginning January 31, 1990. (The Composite has generally been invested in very high-grade, quality issues, and in our view, can serve as an illustration of the broad convertible market.) The Composite posted 24-month rolling returns of more than 20% in the wake of the 1990 and 1995 valuation discrepancies and rolling 24-month returns of about 10% following the 2005 discrepancy.

Historic data for a hedged convertible portfolio is consistent with the data for the unhedged Calamos Convertible Composite. Figure 4b shows very similar historical payoff opportunities for the convertible hedged market, as represented by the HFRI RV Fixed-Income – Convertible Arbitrage Index.

While the past certainly cannot predict the future with absolute certainty, we believe the current level of undervaluation is extreme and may offer long-term investors compelling opportunities. Valuation dislocations can correct quickly and an undervaluation of 10.9% may offer excess returns that are above normal, even in a more subdued equity market environment.

| **Average Annual Returns** (as of 9/30/08) | **1-Year** | **3-Year** | **5-Year** | **10-Year** | **Since Inception of ML V0A0**[1] (1/88) | **Since Strategy Inception** (10/79) |
|---|---|---|---|---|---|---|
| **Calamos Convertible Composite** (gross of fees) | -15.72% | 1.09% | 4.15% | 7.40% | 9.89% | 11.52% |
| **Calamos Convertible Composite** (net of fees) | -16.13 | 0.59 | 3.64 | 6.88 | 9.29 | 10.78 |
| **ML V0A0** | -20.25 | -0.99 | 2.49 | 5.64 | 8.94 | NA |

[1] Returns are shown for the performance of Calamos Convertible Composite since the inception of the Merrill Lynch All U.S. Ex Mandatory Index (V0A0) in January of 1988.

Sources: Russell/Mellon Analytical Services LLC and Calamos Advisors LLC.

**Past performance is no guarantee of future results. Current performance may be higher or lower than the performance quoted.**

The opinions referenced are as of the date of publication and are subject to change due to changes in the market or economic conditions and may not necessarily come to pass. Information contained herein is for informational purposes only and should not be considered investment advice.

Please note that Figures 1, 2a and 2b, 4a and 4b include data derived from Calamos Corporate Systems (CCS), a proprietary valuation system designed and maintained solely by Calamos. While we deem the information contained in the charts to be reliable, Calamos makes no public claims as to the validity of the information derived from the system.

In addition to market risk, there are certain other risks associated with an investment in a convertible bond, such as default risk, the risk that the company issuing debt securities will be unable to repay principal and interest, and interest rate risk, the risk that the security may decrease in value if interest rates increase.

Returns presented from October 1, 1979 through December 31, 1990 are based on the Calamos Convertible Composite, which is an actively managed composite investing primarily in higher-quality foreign and U. S. convertible bonds and is comprised of all fully discretionary, fee-paying, tax-exempt accounts of $250,000 or more, managed by Calamos Advisors LLC. Returns presented from January 1, 1991 through the current period are based on the Calamos Institutional Convertible Composite which is an actively managed composite investing primarily in high-quality U.S. convertible bonds and is comprised of all fully discretionary, fee paying, tax-exempt accounts of $1,000,000 or more, managed by Calamos Advisors LLC.

Fees include the investment advisory fee charge by Calamos Advisors LLC. Returns greater than 12 months are annualized.

Average annual total return measures net investment income and capital gain or loss from portfolio investments as an annualized average assuming reinvestment of dividends and capital gains distributions.

**HFRI RV Fixed Income - Convertible Arbitrage Index:** includes strategies in which the investment thesis is predicated on realization of a spread between related instruments in which one or multiple components of the spread is a convertible fixed income instrument. Strategies employ an investment process designed to isolate attractive opportunities between the price of a convertible security and the price of a non-convertible security, typically of the same issuer. Convertible arbitrage positions maintain characteristic sensitivities to credit quality the issuer, implied and realized volatility of the underlying instruments, levels of interest rates and the valuation of the issuer's equity, among other more general market and idiosyncratic sensitivities. Source: Hedge Fund Research, Inc.© HFR, Inc. 2008. www.hedgefundresearch.com. **Merrill Lynch All U.S. Convertibles Ex Mandatory Index (V0A0)** measures the return of all U.S. Convertibles excluding mandatory convertibles. **S&P 500 Index:** measures the performance of 500 large-cap U.S. companies. Investors cannot invest directly in an index.

Calamos Advisors LLC is a federally registered investment advisor. Part II of Form ADV, which provides background information about the firm and its business practices, is available upon written request to: Calamos Advisors LLC, 2020 Calamos Court, Naperville, IL 60563-2787, Attn: Compliance Officer

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