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March 2013

The Case for Strategic Convertible Allocations

An Analysis of Global Convertible Market Opportunities

Convertible security allocations may be particularly beneficial in the current environment. My experience with convertibles dates to the volatile financial markets of the 1970s. During this period, convertible strategies often provided better returns than either the stock market or bond markets. As a fixed-income security with equity attributes, convertibles may be viewed as offering the best of both worlds.

Today's market conditions are similar to those of the 1970s, as macro events fuel uncertainty and volatility. And, the more uncertain the times, the greater the need to manage risk. We therefore believe the case for convertible securities is as strong as ever, and the use of convertibles in a risk-managed strategy may provide benefits that stock and bond allocations alone cannot.

As we will discuss in this paper, economic growth supports convertible issuance, and recent global trends have affirmed this relationship. We expect that economic growth will continue, providing a tailwind for issuance. Moreover, we believe that a growing economy, even a slow-growth one, provides a favorable environment for a widening pool of convertibles.

In our view, convertible yields remain very competitive relative to traditional fixed income investments, particularly in light of the other potential structural benefits of convertibles. Although coupon rates of convertibles may be lower than in the past, this reflects a global low interest rate environment—the impact of which has been felt across the fixed income market as a whole.

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TABLE OF CONTENTS

I. Introduction: Convertibles and Asset Allocation	3
II. An Evolving Market Environment	4
III. Economic Recovery: A Tailwind For Convertible Issuance	4
IV. A Widening Universe	7
V. Total Return Alternatives: Well Represented in the Convertible Market	7
VI. From a Valuation Perspective, Hunting Grounds Are Fine	8
VII. Synthetic Convertibles Increase the Investable Universe	9
VIII. Convertibles in Rising Interest Rate Environments.	9
IX. Case Study: Calamos Convertible Strategy*	10
X. Conclusion	11

ABOUT THE AUTHOR



John P. Calamos, Sr. is chairman, chief executive officer and global co-chief investment officer of the firm he founded in 1977, which he took public as Calamos Asset Management in 2004 (Nasdaq: CLMS). A recognized authority on convertible securities, he has pioneered investment strategies and techniques to help manage risk for major institutional and individual investors for more than 35 years.

Mr. Calamos received his undergraduate degree in Economics and M.B.A. in Finance from the Illinois Institute of Technology. He joined the United States Air Force after graduation, served as a combat pilot during the Vietnam War, and ultimately earned the rank of Major. While in the Air Force, Mr. Calamos became intrigued by the risk management aspects of convertible bonds. By applying option price theory to the valuation of convertibles he was able to demonstrate the benefit of convertibles as part of an investment strategy.

He has shared his expertise in two books, *Convertible Securities: The Latest Instruments, Portfolio Strategies, and Valuation Analysis* (McGraw-Hill, 1998) and *Investing in Convertible Securities: Your Complete Guide to the Risks and Rewards* (Longman Financial Services Publishing, 1988). He has also authored numerous articles in various financial journals and is a frequent guest on nationally syndicated financial networks.

*Strategy data has been updated through March 31, 2013.

I. INTRODUCTION: CONVERTIBLES AND ASSET ALLOCATION

Convertible securities are equity-linked instruments that offer the upside for equity market participation with potential downside resilience in periods of equity market declines. In simplest terms, a convertible is a fixed income security that includes an embedded option. Structurally, the risk/reward characteristics of convertibles allow them to support a range of asset allocation goals. However, convertible securities are also complex—not only because the attributes of convertibles may differ considerably, but also because a convertible may be more equity-like at certain periods and more fixed income-like in others.

Because of their structural complexities, convertible securities demand active management within asset allocations. Often, convertible securities are thought of as a single asset class; this ignores the variations within the convertible universe. Our approach is to use different convertibles within specific investment strategies. It is not simply the convertibles that make a strategy work, but how convertibles are managed to achieve a particular investment objective.

Convertibles with higher levels of equity sensitivity may be utilized within lower-volatility equity allocations, providing an innovative solution for investors who wish to participate in equity markets but are concerned about downside equity volatility. (In volatile markets, the bond value provides a floor, and through coupon income, investors are “paid to wait” for the markets to turn.)

Convertibles may serve a role within enhanced fixed income allocations. Convertibles have historically performed well during periods of rising interest rates and inflation, and therefore convertible strategies may be used to diversify a traditional fixed-income portfolio (i.e., government bonds) as a high yield corporate bond allocation might. In such cases, we would expect to utilize a greater proportion of convertibles with more pronounced fixed-income characteristics, such as “busted convertibles.” Additionally, convertibles with a range of characteristics can be used within alternative allocations, such as hedge strategies that employ convertible arbitrage.

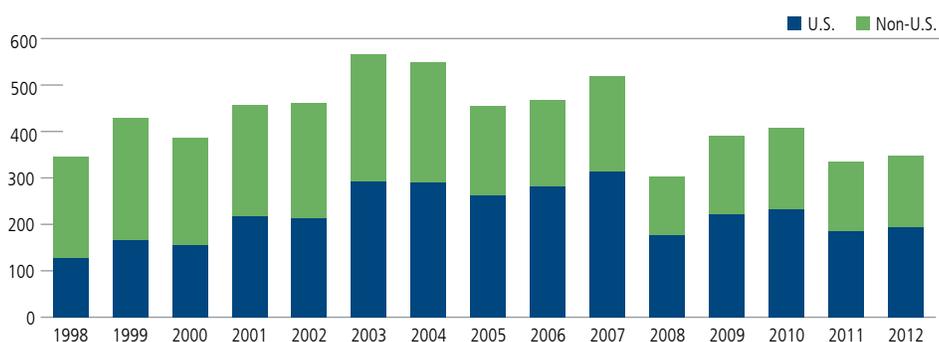
▸ It is not simply the convertibles that make a strategy work, but how convertibles are managed to achieve a particular investment objective.

As better economic prospects spur increased interest in risk assets, we would expect a resurgence in convertible issuance.

II. AN EVOLVING MARKET ENVIRONMENT

The dynamics of all asset classes ebb and flow due to economic and market factors, issuance trends and investor sentiment. Convertible securities are no exception. Over recent years and against a global backdrop of low interest rates, many companies chose to issue non-convertible debt. However, the size of the convertible market has risen from 2008 lows, and the U.S. market is actually larger than it was 12 to 14 years ago (Figure 1).

FIGURE 1. ASSET LEVELS HAVE STABILIZED IN THE GLOBAL CONVERTIBLE MARKET (\$ BIL)

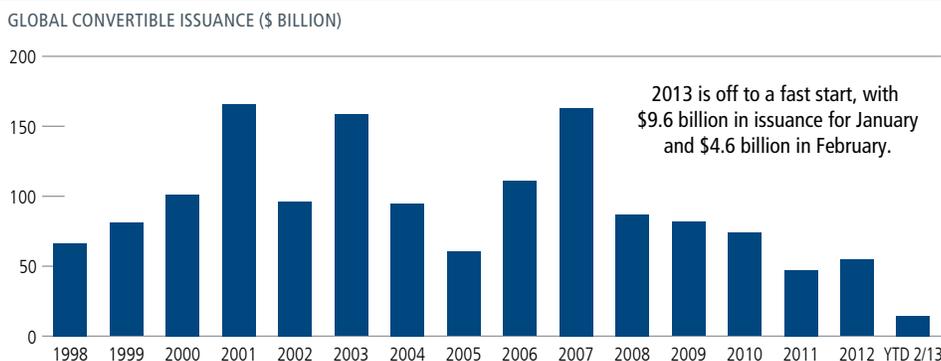


Source: BofA Merrill Lynch

III. ECONOMIC RECOVERY: A TAILWIND FOR CONVERTIBLE ISSUANCE

Convertible market issuance is about capital market access; capital market access is closely tied with economic growth. As better economic prospects spur increased interest in risk assets, we would expect a resurgence in convertible issuance. This has been born out lately, as we have seen favorable issuance trends (Figure 2) as global recovery progresses. Certainly, some of this will be offset by maturing securities, which are

FIGURE 2. ECONOMIC RECOVERY HAS SUPPORTED MORE ROBUST ISSUANCE



Source: BofA Merrill Lynch

expected to increase over these next quarters. We will be closely monitoring retirement and call activity. However, we believe that economic growth trends support the long-term viability of the asset class.

Euro zone. We see the impact of economic recovery and issuance playing out in the European market, in particular. As the resolve of the euro zone and the commitments of the ECB mitigated the tail risk of break-up, European convertible issuance ramped up notably in the final months of 2012. For the year, issuance totaled \$23.6 billion, surpassing annual U.S. issuance of \$21.1 billion. Through February 2013, European issuance has totalled a robust \$6.6 billion.

A number of factors support the growing role of the euro zone within the convertible market. Interest rates (while still low) are somewhat higher than in the U.S., especially in countries with higher country risk premiums, such as Italy and Spain, both of which have contributed to 2013 issuance. With the rebound in the equity markets, equity valuations are better, which may make companies more comfortable with including an option on their equity in their debt. Lastly, an improved global market economic environment raises the probability of the equity reaching its conversion price. Issuers prefer to see the debt retired by conversion than by refinancing so the improved confidence in higher future equity valuations is a positive. Moreover, issuers can bring convertibles to market quickly by going directly to investors. Given the state of flux in Europe, disintermediation may provide a strong incentive versus other financing forms that have more lengthy IPO windows.

United States. As we noted, improved economic prospects have contributed to increased convertible issuance in Europe. We are seeing similar trends play out in the U.S. market as economic recovery continues. Through February 2013, yearly U.S. issuance stands at \$4.9 billion. Recent U.S. issues have come from recovering market sectors, such as homebuilders and financials. However, issuance has also been broad-based from a sector perspective. Within the BofA Merrill Lynch New Issuance Index, nine of 10 sectors are represented over the six months ended February 28, 2013. Additionally, February alone saw 10 new issues come to market, representing \$3.5 billion.

Japan. We are watching Japan with great interest. Before its deflationary malaise set in, Japan was an important participant in the convertible market, especially in the late 1980s when a friendly regulatory environment helped fuel a tremendous surge of issuance.

▸ A number of factors support the growing role of the euro zone within the convertible market.

A NOTE ON UNRATED CREDITS

Non-rated issues make up a significant percentage of the global and U.S. convertible markets. Often, companies forego having their securities rated at the outset, avoiding a lengthy and expensive process. We can invest in non-rated convertible securities, but will do so only after rigorous research. Among many factors, we will consider company fundamentals, balance sheet data, debt servicing prospects, and the ratings of other securities within a company's capital structure.

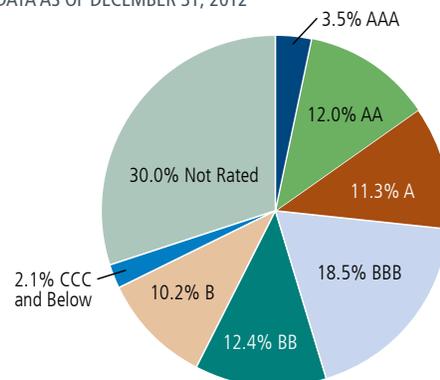
Significantly, interest rates were low during this period; issuance was supported by economic growth. Prime Minister Abe's commitment to pushing through economic growth initiatives could set the stage for increased convertible issuance.

Emerging Markets. Turning from the developed markets, we are often asked for our views on convertibles issued by companies based in emerging markets (EMs). At present, the size of the EM convertible market remains relatively small. Presently, the BofA Merrill Lynch Emerging Markets Convertible Index comprises 75 issues, with a market value of \$24.3 billion (USD). However, we expect opportunities to grow over time as (1) EM economies continue to prosper, (2) their capital markets mature and (3) EM companies rely less on bank financing. This trend, while fledgling, is underway: companies based in emerging Asia—China, India, Taiwan, Hong Kong—have made notable contributions to 2013 issuance. While we cannot forecast the magnitude of near-term EM convertible expansion, we believe it remains a compelling long-term trend to watch.

A Global Evolution. We do not view the larger role of non-U.S. issues as a negative for U.S. convertible strategies. Increased global acceptance and growing interest in convertibles may help spur other companies, including U.S.-based ones, to issue convertibles. However, as investors who believe wholeheartedly in the global growth story, we do believe that the evolution of the convertible market should prompt investors to consider broader geographic participation as well—akin to the expanding role of non-U.S. companies within equity allocations.

FIGURE 3. GLOBAL CONVERTIBLE MARKET: CREDIT QUALITY COMPOSITION

DATA AS OF DECEMBER 31, 2012



Investment-grade and mid-grade credits are well represented in the global convertible market.

Source: BofA ML Convertible Research, G300 Index

IV. A WIDENING UNIVERSE

As we discussed in our most recent [Global Economic Review and Outlook](#), our global outlook is one of cautious optimism. We expect continued volatility, driven in large measure by political uncertainty (sequestration, the Italian election and austerity around the euro zone). But the U.S. is on a slow-but-steady course, China has regained its footing, and the euro zone has demonstrated considerable resolve. In this environment, we believe that we can consider a wider range of credits.

V. TOTAL RETURN ALTERNATIVES: WELL REPRESENTED IN THE CONVERTIBLE MARKET

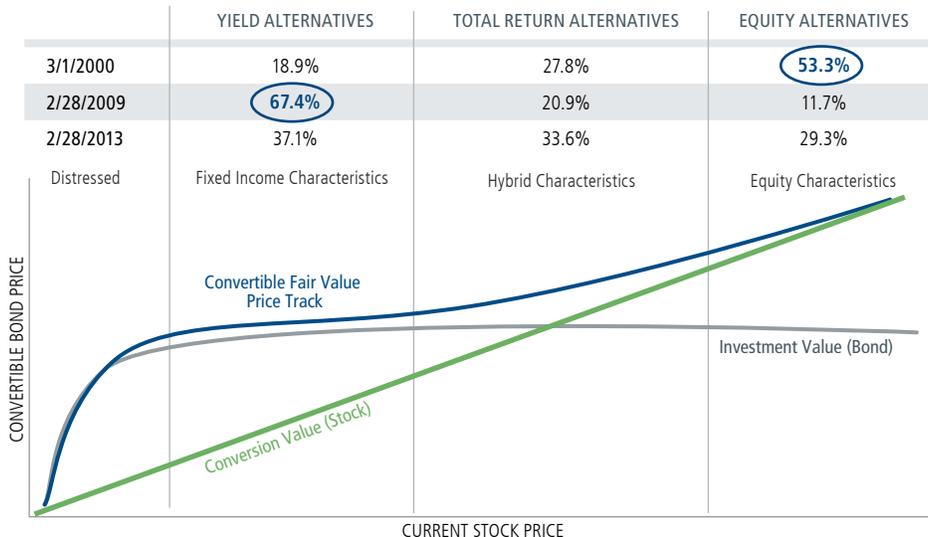
As previously noted, convertibles have varying degrees of equity and fixed-income sensitivity, and these characteristics may change for a given convertible over time. Although the universe of convertibles may be smaller than at other points, a sufficient percentage meet our criteria.

For example, in our management of a number of U.S. and global convertible strategies, our goal is to provide an asymmetrical risk profile with greater equity market participation than downside over full market cycles. In these portfolios, we generally prefer “total return alternatives”—those that offer a more even balance of equity and credit sensitivities. In defensive equity strategies, we would rather give up some upside in exchange for potentially greater resilience on the downside. Presently, one third of U.S. convertible issues have the “total return” characteristics we seek—more than at other periods (Figure 4).

▸ The evolution of the convertible market should prompt investors to consider broader geographic participation as well—akin to the expanding role of non-U.S. companies within equity allocations.

FIGURE 4. THE MARKET CYCLE AND U.S. CONVERTIBLE CHARACTERISTICS

AS OF FEBRUARY 28, 2013



Source: BofA Merrill Lynch, All U.S. Convertibles Index (VXA0)

Convertibles have different levels of equity and credit sensitivity. As we have noted, it is not simply the convertibles that make a strategy work. What matters is how specific convertibles are managed to achieve an investment objective.

Notice the large percentage of equity-sensitive convertible securities in March of 2000.

By February of 2009, “busted convertibles” dominated the market.

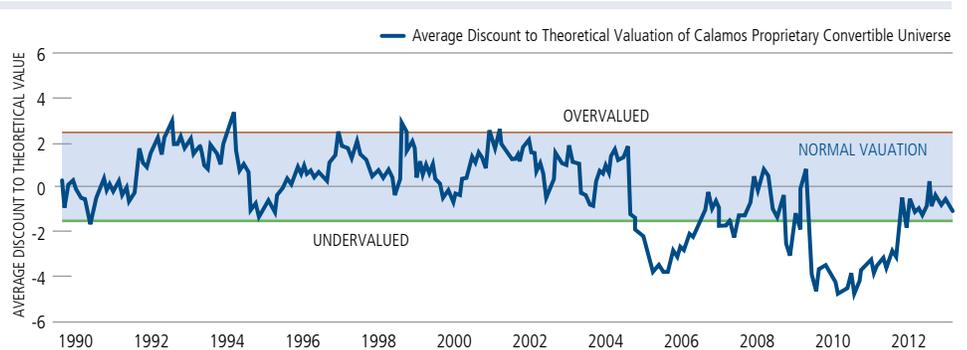
In contrast, the convertible market demonstrated a much higher degree of equity sensitivity in March of 2000, against the backdrop of a peaking equity market and technology bubble. In February of 2009, the pendulum had swung to the other extreme. As the markets troughed in the liquidity crisis, more than two-thirds of convertible markets were trading as “credit-sensitive.” To use the Goldilocks analogy, the convertible market entering March of 2000 was too hot, and in February of 2009 it was too cold. Right now, we feel it’s just right.

VI. FROM A VALUATION PERSPECTIVE, THE HUNTING GROUNDS ARE FINE

In 2008, systemic risk led to unparalleled valuation opportunities within convertibles. No other period came close to the undervaluation level recorded in the second half of 2008, when we saw an 11% discount to theoretical fair value, based on our fair value proprietary methodology. The valuation gap has since returned to the lower end of what we would consider the normal valuation band (Figure 5).

Does this normal valuation band mean that investors should look elsewhere? In our view, the answer to that question is a resounding “no.” It does however speak to the importance of actively managed strategies versus passive ETFs. Since we began managing convertible portfolios in the 1970s, we have invested through many valuation climates. We are not looking to buy the asset class as a whole, but rather, to construct portfolios of securities most likely to deliver the specific risk/return profiles we seek.

FIGURE 5. ALL U.S. CONVERTIBLES, JANUARY 31, 1990 TO DECEMBER 31, 2012



Past performance is no guarantee of future results. Current performance may be higher or lower than the performance quoted. Please note that the chart above includes data derived from Calamos Corporate Systems (CCS), a proprietary valuation system designed and maintained solely by Calamos. CCS data is unavailable prior to 1/31/90. 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. Source: Calamos Corporate System (CCS).

VII. SYNTHETIC CONVERTIBLES INCREASE THE INVESTABLE UNIVERSE

We have noted the unknown impact of maturing securities on issuance trends. Our investable universe is not solely dictated by convertible issuance, however, due to our use of synthetic convertibles.

A convertible bond can be thought of as the sum of its parts, that is a straight bond combined with a long-term call option (the right to convert the bond into stock). A synthetic convertible can be constructed by purchasing these parts in such quantities to provide the balanced risk/reward attributes that we seek. This allows us to synthetically create a convertible security for a company that may not have any convertible or even non-convertible debt outstanding. The bond component could be a credit instrument of any kind, including a Treasury bond, sovereign debt or a straight corporate bond. The synthetic convertible is created when this credit instrument is combined with a long-term call option such as long-term equity anticipation securities (LEAPS) or warrants.

VIII. CONVERTIBLES IN RISING INTEREST RATE ENVIRONMENTS

Interest rates have been extremely low, but we believe long-term investors should address the potential for rising-rate environments within their asset allocations. An improving economy or rising inflation could spur a rise in interest rates, and historically, rate increases have happened quickly and unexpectedly. Global monetary easing has been unprecedented, and it will be a complex undertaking to unwind these policies without adverse effect.

Bonds tend to lose value in an environment of rising interest rates. However, convertible returns have tended to more closely reflect equity returns than bond returns when the 10-year Treasury yield rose more than 100 basis points (Figure 6).

FIGURE 6. RETURNS IN RISING INTEREST RATE ENVIRONMENTS

	10/15/93- 11/7/94	1/18/96- 6/12/96	10/5/98- 1/20/00	11/7/01- 4/1/02	6/13/03- 6/14/04	6/1/05- 6/28/06	12/30/08- 6/10/09	10/7/10- 2/8/11
Yield Increase (bps)*	287	154	263	125	176	136	189	115
BofA Merrill Lynch All U.S. Convertibles Index	-2.28%	11.97%	68.85%	2.29%	11.49%	9.46%	24.68%	11.63%
S&P 500 Index	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89
Barclays U.S. Government/ Credit Index	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94

Past performance is no guarantee of future results.

*10-year Treasury yield Performance shown is cumulative. Sources: Morningstar and Bloomberg

Interest rates have been extremely low, but we believe long-term investors should address the potential for rising-rate environments within their asset allocations.

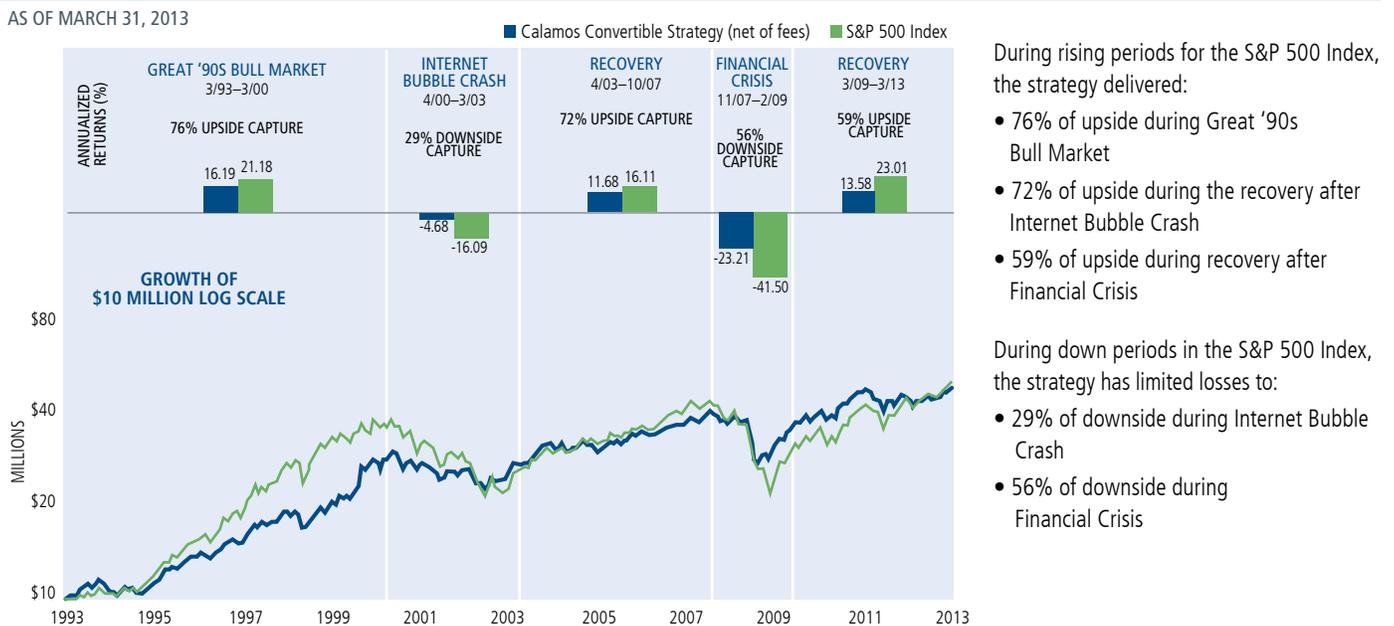
While convertibles are influenced to a degree by interest-rate fluctuations, they also are affected by the price movements of their underlying stocks, a factor that historically has helped soften the negative effect of rising interest rates. In general, the more a convertible's price is determined by the value of its underlying equities, the greater its tendency not to be influenced by changing interest rates.

IX. CASE STUDY: CALAMOS CONVERTIBLE STRATEGY

The Calamos Convertible Strategy is one of the oldest convertible strategies in the marketplace, with an inception of 1979. We believe the performance of the strategy speaks to potential benefits of including convertible securities as a long-term strategic allocation (Figure 7).

Through our positioning, we endeavor to provide an asymmetrical risk/return profile over full market cycles. Because of the premium we place on mitigating downside, our approach may trail during periods of rapidly advancing markets. This emphasis on capital preservation also sets us apart from investment managers that invest more heavily in the most speculative issues. In our view, the risk-management opportunities of convertible securities are too compelling to overlook within an overall asset allocation.

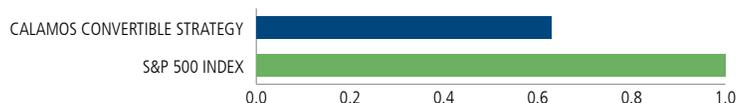
FIGURE 7. MANAGING RISK OVER MARKET CYCLES: A 20 YEAR ILLUSTRATION, CALAMOS CONVERTIBLE STRATEGY VERSUS THE U.S. EQUITY MARKET



Past performance is no guarantee of future results. Logarithmic scales can be useful when looking at performance data over a long period of time. Common percent changes are represented by an equal spacing between the numbers in the scale. For example, the distance between \$1 and \$2 is equal to the distance between \$2 and \$4 because both scenarios represent a 100% increase in price. Source: Mellon Analytical Solutions LLC.

FIGURE 8. SINCE INCEPTION BETA

AS OF MARCH 31, 2013



Past performance is no guarantee of future results.

Source: Mellon Analytical Solutions LLC, Calamos Advisors LLC and State Street Corp. Beta is a measure of stock market correlation or risk.

The strategy's historic lower volatility characteristics are illustrated by its beta since inception (Figure 8). Over 20 years, the Calamos Convertible Strategy Composite has outperformed the equity benchmark with a beta of 0.63 and an annualized alpha (or risk-adjusted return) of 1.88% versus the S&P 500 Index.

X. CONCLUSION

We believe the case for strategic convertible allocations remains strong. Strategic convertible allocations may provide investors with opportunities to manage both returns and risk in ways that stocks or bonds cannot. We also expect that the structural characteristics of convertibles (the opportunity for upside equity participation with a degree of downside resilience) may serve investors well, given our view that global political uncertainties will contribute to high levels of volatility.

We are encouraged by recent global issuance trends and believe that economic growth can support new opportunities for convertible investors, even if interest rates remain low. We are particularly interested in the growing role of non-U.S. issuance; to us, it underscores the ongoing evolution of the asset class. In an environment of slow-but-positive growth, we also believe that we can consider a wider range of credit qualities while still maintaining our focus on downside risk management. We are confident that our long track record speaks to our ability to identify convertible opportunities in a variety of market environments.

For additional information about convertible securities and asset allocations, please visit us at www.calamos.com. You can also contact us at [800.582.6959](tel:800.582.6959), and we will provide resources that best address your specific needs.

▸ We believe the case for strategic convertible allocations remains strong.

ANNUALIZED PERFORMANCE, CALAMOS CONVERTIBLE STRATEGY

DATA AS OF MARCH 31, 2013

	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR	SINCE V0AO INCEPTION (1/88)	SINCE STRATEGY INCEPTION (10/79)
Return Gross of Fees	6.64%	6.79%	5.89%	7.53%	6.84%	9.75%	11.19%
Return Net of Fees	5.95	6.23	5.35	7.00	6.32	9.16	10.48
BofA ML All U.S. Convertibles Ex Mandatory Index (V0AO)	12.35	9.67	7.60	7.75	6.41	9.48	N/A
S&P 500 Index	13.96	12.67	5.81	8.53	4.27	10.05	11.37

Past performance does not guarantee or indicate future results. Current performance may be lower or higher than the performance quoted. Portfolios are managed according to their respective strategies which may differ significantly in terms of security holdings, industry weightings, and asset allocation from those of the benchmark(s). Portfolio performance, characteristics and volatility may differ from the benchmark(s) shown.

The results portrayed on the preceding pages are for the Calamos Institutional Convertible Composite. Representative holdings and portfolio characteristics are specific only to the portfolio shown at that point in time. Other portfolios will vary in composition, characteristics, and will experience different investment results. The representative portfolio shown has been selected by the advisor based on account characteristics that the advisor feels accurately represents the investment strategy as a whole. Supplemental information has been provided for the Institutional Convertible Composite.

Returns presented from January 1, 1991 through the current period are based on the Calamos Institutional Convertible Composite. This is an actively managed composite investing primarily in high-quality U.S. convertible bonds, which is comprised of fully discretionary, fee-paying, tax-exempt accounts of \$1,000,000 or more, managed by Calamos Asset Management, Inc. Returns presented from October 1, 1979 through December 31, 1990 reflect the Calamos Convertible Composite. This is an actively managed composite investing in higher-quality foreign and U.S. convertible bonds, which is comprised of fully discretionary, tax-exempt, fee-paying accounts of \$250,000 or more managed by Calamos Asset Management, Inc. All returns are net of commission and other similar fees charged on securities transactions and include reinvestment of net realized gains and interest.

Fees include the investment advisory fee charged by Calamos Advisors LLC. Returns greater than 12 months are annualized. Chart Data Sources: Russell/Mellon Analytical Services LLC and Calamos Advisors LLC.

The Bank of America Merrill Lynch All US Convertibles Ex Mandatory Index (V0AO) is broadly representative of the U.S. convertible securities market, consisting of publicly traded issues, denominated in U.S. dollars, of all credit qualities, and excluding mandatory (equity-linked) convertibles. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value weighted index (stock price times number of shares outstanding), with each stock's weight in the index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

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