

Feature: Fixed Income

The dual equity/bond features of convertible bonds are increasing in popularity as developed markets recover from recessionary lows. But what is the best way to access them? John P. Calamos, CEO of Calamos Investments, tells *Investment Week* his strategy

Spotlight on: Convertible bonds

Convertible strategies are enjoying a resurgence in the current environment of potential higher interest rates and increased volatility.

In the first four months of 2014, convertible valuations have benefited from a confluence of factors, including a narrowing of bond market spreads and equity market volatility. Growing concern about the impact of rising interest rates (most immediately in the US) on straight debt has furthered the appeal of the asset class because convertibles' equity characteristics have made them less vulnerable to rising interest rates compared with non-convertible debt.

With this supportive backdrop, convertible securities have outpaced equities through April 2014, with the Bank of America Merrill Lynch Global 300 index up 2.5%, versus a gain of 1.9% for the MSCI World index.

Chief executive officer and global co-chief investment officer of Calamos Investments, John P. Calamos Sr. said, "Having closely followed the evolution of the asset class through the decades, we are excited by many trends in the global convertible markets, including first quarter issuance of nearly \$21bn."

New issuance

Calamos believes the macro landscape is likely to encourage companies to bring more issues to market in 2014. He said: "Convertible issuance is about capital market access, which tends to improve as economic recovery progresses. Over recent months, this relationship has been illustrated by the \$6.1bn of new issuance coming out of Europe during the first quarter of 2014."

But these securities may prove challenging for the novice investor. Convertibles have varying degrees of equity and credit sensitivity. Those issues with higher equity sensitivities perform more like stocks, while those with higher credit sensitivity behave more like bonds. These characteristics may change for a given convertible over time, as well as for the convertible universe as a whole.

Because of the complexity, Calamos suggested: "It is not simply including convertibles that makes a strategy work. What matters is how convertibles are managed to achieve a desired outcome."

Hybrid features

The value of a convertible security is influenced by many factors, including the performance of the underlying stock, its volatility and coupon. As shown in the graphic, as the stock price of the convertible's issuer moves upward or downward, the convertible will become more or less equity sensitive, respectively.

When stock prices drop too low, the bond value of the convertible can provide a price floor for the convertible. Through active management, an investor can capitalise on these hybrid features, for example, to achieve lower volatility participation in the equity market or lower interest rate sensitivity.

Active management

Active management is the key, according to the group.

For example, the stronger performance of the equity markets over recent years has resulted in a

global convertible market with a high degree of equity sensitivity, particularly in the US market. This creates both opportunities and risks.

Calamos explained: "Higher equity sensitivity positions many convertibles to capture equity market upside. However, that same equity sensitivity may leave a convertible open to more downside.

"The merits of convertibles are most fully exploited when they are managed to create a portfolio with an asymmetrical risk profile – that is, one with more upside than downside over full market cycles. This asymmetry may be very different at times from what the convertible market universe is exhibiting overall."

The 'total return' convertibles which offer a balance of equity and fixed income characteristics is favoured by Calamos Advisors.

Although there has been an upswing in issuance, much has been below-investment grade, or unrated as companies forego the costs associated with securing a rating. In such an environment, a depth of proprietary research can provide advantages.

According to Calamos, convertible portfolios asset allocation can be enhanced with active management by potentially:

1 Dampening volatility

With fixed income attributes, convertibles may provide lower-volatility participation in the equity market over full market cycles. This could provide added comfort to investors who wish to participate in the equity market, but are concerned about downside.

2 Reducing interest rate vulnerability

Historically, convertibles have been less sensitive to rising interest rates versus traditional bonds. As such, convertibles provide investors with a way to mitigate the impact of rising rates.

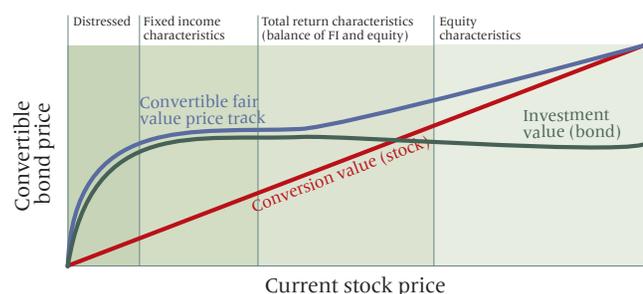
What is a convertible bond?

A convertible bond is a fixed income security with an embedded option to convert into the equity shares of the issuer. This hybrid structure provides the opportunity for upside participation in the equity markets, as well the potential for downside protection from its fixed income attributes if the underlying stock declines.

Although many investors are considering convertibles for the first time, the asset class dates to the 19th century, when US railroad companies issued them.

Today, the convertible market is a global asset class valued at \$363bn, and reflects considerable diversity by industry, geography, and issuer terms.

US convertible characteristics and the market cycle



Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable, but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. The opinions and views of third parties do not represent the opinions or views of Calamos Investments LLC. Opinions referenced are as of the day recorded and are subject to change due to changes in the market, economic conditions or changes in the legal and/or regulatory environment and may not necessarily come to pass. This information is provided for informational purposes only and should not be considered tax, legal, or investment advice.

Convertible Securities Risk: The value of a convertible security is influenced by changes in interest rates, with investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other

factors also may have an effect on the convertible security's investment value.

Convertible Hedging Risk: If the market price of the underlying common stock increases above the conversion price on a convertible security, the price of the convertible security will increase. The increased liability on any outstanding short position would, in whole or in part, reduce this gain.

The Bank of America Merrill Lynch Global 300 Convertible Index (VG00) is a global convertible index composed of companies representative of the market structure of countries in North America, Europe and the Asia/Pacific region.

The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe, and Asia/Pacific region.

Outside the United States, this document is directed only at professional/sophisticated investors and it is for their use and information. This document should not be shown or given to retail investors. Any entity responsible for forwarding this ma-

terial to other parties takes responsibility for ensuring compliance with the financial promotion rules.

Calamos Investments LLC, referred to herein as Calamos Investments®, is a financial services company offering such services through its subsidiaries: Calamos Advisors LLC, Calamos Wealth Management LLC, Calamos Investments LLP and Calamos Financial Services LLC.

©2014 Calamos Investments LLC. All Rights Reserved. Calamos® and Calamos Investments® are registered trademarks of Calamos Investments LLC.