

Perspectives on Credit Quality and Convertibles

BY ELI PARS, CFA, SVP AND SENIOR CO-PORTFOLIO MANAGER

Since the late 1970s, Calamos has used convertible securities to provide our clients with attractive risk-adjusted returns over full market cycles. The hybrid nature of convertibles allows them to be used to pursue a wide range of investment goals. We have long believed that the unique advantages of convertibles are best harnessed through actively managed strategies that seek an asymmetrical risk/return profile—that is, one with more equity upside than downside.

We have spoken with many clients who initially believed that a portfolio built exclusively from investment grade convertibles is inherently safer than a portfolio that also includes below investment grade and non-rated securities. Our view is that in the current environment, the opposite may be true. Strategies that are not confined to investment grade issues offer enhanced opportunities to pursue a broader range of growth opportunity and to mitigate risk over full market cycles. Moreover, the merits of an unconstrained approach may be especially pronounced in the current environment.

Our approach focuses on managing aggregate portfolio risk, which extends beyond credit risk to also include issuer diversification, sector risk and equity sensitivity risk.

» **An investment grade portfolio may be subject to a shrinking opportunity set, as investment grade convertibles make up a small and decreasing segment of the overall universe at present.** As of July 15, 2014, the 300 securities within the BofA Merrill Lynch Global 300 Index had a total market value of more than \$170 billion dollars (USD). However, the index includes just 44 investment grade issues out of 300, with a total market value of \$37.6 billion.

Moreover, the largest five investment grade issues represent 31% of the investment grade issues within the G300 Index, while the largest 10 represent 54%.

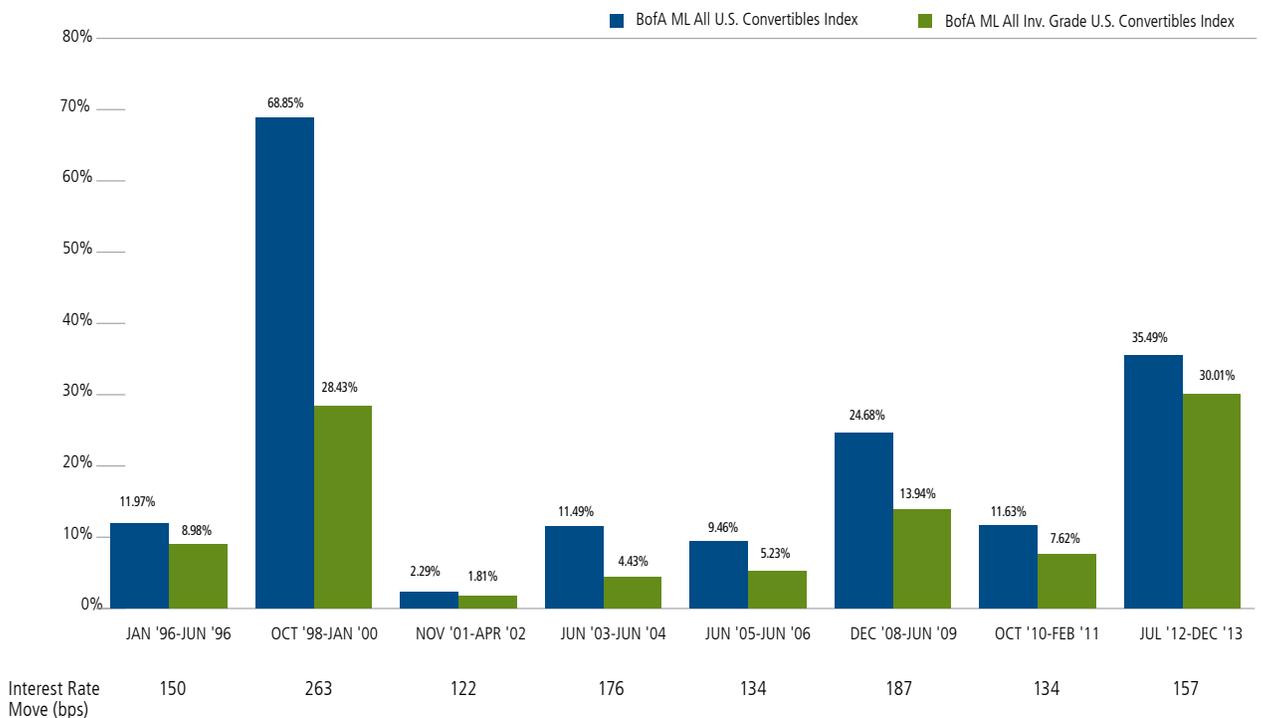
There's a similar issue in the U.S. market. The BofA Merrill Lynch All U.S. Convertibles Index included 484 issues as of July 15, with a total market value of \$209 billion. The investment grade subset, the BofA Merrill Lynch VXA1 Index, included just 61 names, valued at \$47.7 billion.

» **Non-investment grade securities have dominated recent issuance.** Global convertible issuance has been very promising of late, a trend which we expect will continue, supported by continued global economic recovery. Recent issues have exhibited attractive characteristics and terms, as well as good breadth by sector, geography and market cap. However, recent issuance has been largely dominated by non-investment grade issuers, as investment grade issuers have continued to find inexpensive financing in traditional debt.

Within the global market, 148 issues have been brought to market through the first half of 2014, with a value of \$52.3

Global Convertible Market Commentary

FIGURE 1. IN RISING RATE ENVIRONMENTS, INVESTMENT GRADE CONVERTIBLES TYPICALLY LAGGED THE CONVERTIBLE UNIVERSE



Performance data quoted represents past performance, which is no guarantee of future results. Source: Morningstar Direct and Bloomberg. Rising rate environment periods from troughs to peak from January 1996 to December 2013. Most recent data available as of 3/31/15.

billion. However, only \$4.3 billion of this issuance has been rated investment grade, in six issues. Similarly, within the U.S. market, 61 new issues were brought to market during the first half of the year, with a value of \$23.5 billion. Just four issues (\$3.0 billion) of these were rated investment grade. European investment grade issuance stands at \$1.3 billion, out of total issuance of \$15.9 billion, while no investment grade issuance has come out of the Asian and Japanese markets during the first half of the year.

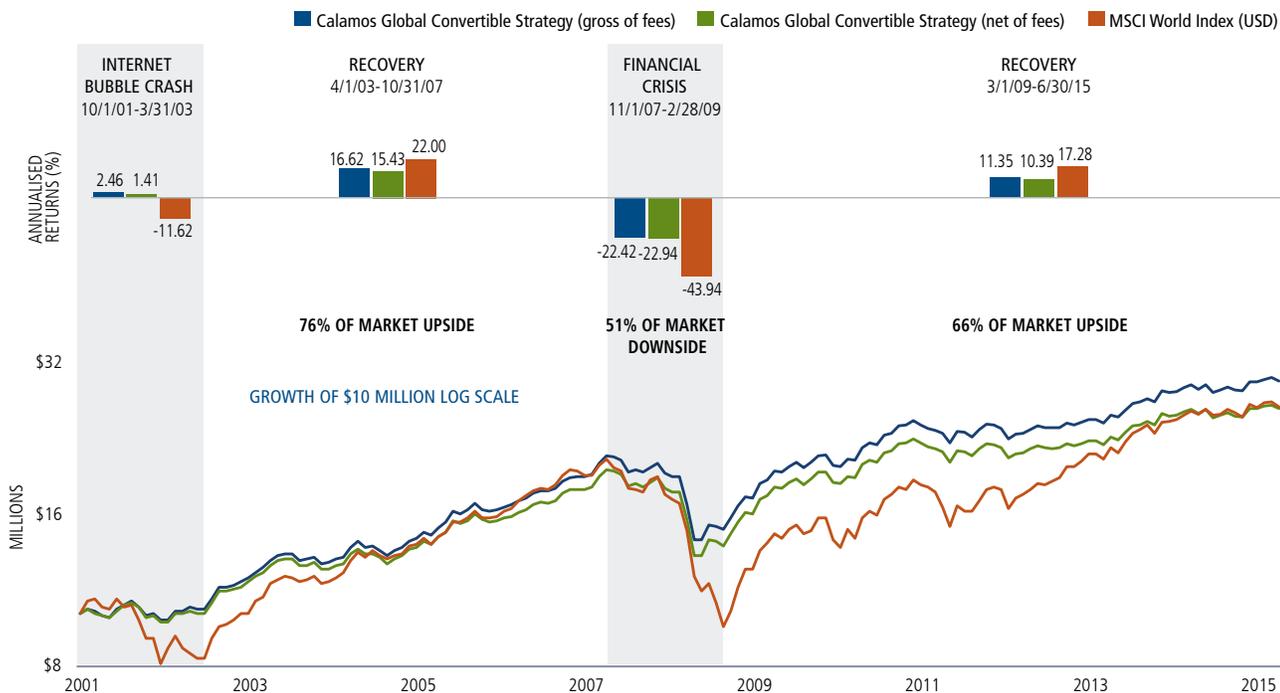
» **Investment grade convertibles have typically underperformed the broad convertible universe when interest rates rise.** During the past 20 years, there have been eight periods when the 10-year Treasury yield rose more than 100 basis points (Figure 1). During all of these periods, the BofA Merrill Lynch All Investment Grade U.S. Convertibles Index lagged the BofA Merrill Lynch All U.S.

Convertibles Index. While rates are still low, investors should be positioned proactively for an eventual rate increase.

- » **An investment grade portfolio may also be subject to a higher level of equity sensitivity, and therefore, downside equity capture—precisely the risk that most convertible investors seek to avoid.** In the current environment, we believe a portfolio composed exclusively of investment grade issues would be subject to a level of equity risk that is higher than most convertible investors would anticipate or intend. While this equity sensitivity may in fact mitigate some of the interest rate risk we discussed above, we believe the profile of much of the investment grade market is not what investors have come to expect.
- » **Quality restrictions increase valuation risk at points of the market cycle.** Our team continues to identify a range of attractively valued securities in the convertible market.

Global Convertible Market Commentary

FIGURE 2. AN UNCONSTRAINED APPROACH HAS BEEN INSTRUMENTAL IN MANAGING RISK OVER MARKET CYCLES



*Strategy data has been updated through the most recent quarter. Data as of 6/30/15.

Past performance is no guarantee of future results. Current performance may be lower or higher than the performance quoted. The principal value and return of an investment will fluctuate so that your shares, when redeemed, may be worth more or less than their original cost. For the most recent strategy performance information, visit www.calamos.com. Index data shown is from 10/1/01, since comparative index data is available only for full monthly periods. 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.

However, there are pockets of the market where we believe convertibles are generally fully valued—including a range of investment grade issues. We do expect that equity markets will continue to rise, but believe the global rotation that ran from mid-March to June illustrates that the highest priced securities may be vulnerable to the increased downward pressure when market sentiment wavers. Historically, overpriced bonds often underperform when the market moves in either direction.

Our experience in convertibles, our seasoned investment team, and our capital structure research process positions us to understand the potential upside and downside associated with non-investment grade issues. We are pioneers in the convertible space and have invested through

multiple market cycles, as the convertible asset class has evolved globally.

We believe we are well equipped to assess convertibles across the credit quality spectrum because of our time-tested investment process and decades of proprietary research. We utilize both equity analysis and credit analysis to evaluate businesses within an enterprise valuation framework. This comprehensive capital structure research is a key differentiator versus other convertible managers, and provides us with an edge in evaluating position specific and aggregate risks.

Our results demonstrate our ability to execute on an unrestricted mandate. In Figure 2, we illustrate the performance of our global convertible strategy. The strategy

Global Convertible Market Commentary

has achieved the asymmetrical risk profile we seek. During the Internet bubble crash, we generated positive returns whilst the broad equity market declined more than 11%. The strategy also proved significantly more resilient during the financial crisis. The strategy has also captured 76% and 66% of the market upside in the recovery periods following the Internet bubble crash and the financial crisis, respectively.

Throughout the decades, we have seen the convertible market evolve and cycle through different issuance dynamics. This experience drives our view that an unconstrained strategy provides the best opportunities through full and multiple market cycles. Investment grade issuance may at some point provide a wider universe of opportunities and more attractive risk/reward characteristics, and an unconstrained approach could adjust to this different environment. But at present time, we believe that a strategy restricted to investment grade securities would not be optimally positioned to capture the most important advantages that convertibles can provide—increased upside equity participation with reduced downside participation.

ABOUT ELI PARS



Eli Pars is a Senior Vice President and Senior Co-Portfolio Manager with specializations including global convertibles and convertible arbitrage. He re-joined the firm in 2013 and has 28 years of industry experience. Mr. Pars has extensive research and portfolio management experience in convertible securities and convertible arbitrage strategies.

Prior to returning to Calamos, Mr. Pars was a Portfolio Manager at Chicago Fundamental Investment Partners, where he co-managed a convertible arbitrage portfolio. Previously, he held senior roles at Mulligan Partners LLC, Ritchie Capital and SAM Investments/ The Hampshire Company. Earlier in his career, Mr. Pars was a Vice President and Assistant Portfolio Manager at Calamos. Mr. Pars received a B.A. in English Literature from the University of Illinois and an M.B.A. with a specialization in Finance from the University of Chicago Graduate School of Business.

ANNUALIZED TOTAL RETURNS AS OF 6/30/15

	1-YEAR	3-YEAR	5-YEAR	10-YEAR	SINCE INCEPTION (10/01)
Calamos Global Convertible Composite (gross of fees)	1.74%	8.48%	8.18%	7.95%	8.21%
Calamos Global Convertible Composite (net of fees)	0.20	7.22	7.15	7.00	7.22
BofA ML Global 300 Convertible Index (USD)	1.41	10.22	9.11	7.13	6.97
MSCI World Index (USD)	1.97	14.90	13.72	6.96	7.29

*Strategy data has been updated through the most recent quarter.

Past performance is no guarantee of future results. The results portrayed on the preceding pages are for the Calamos Global 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 Global Convertible Composite.

The Calamos Global Convertible Composite is an actively managed composite investing primarily in a globally diversified portfolio of convertible securities. The composite includes all fully discretionary fee-paying accounts, including those no longer with the Firm. Accounts valued at less than \$1,000,000 are not included. 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 charge by Calamos Advisors LLC. Returns greater than 12 months are annualized. Chart Data Sources: Mellon Analytical Solutions LLC and Calamos Advisors LLC.

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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 Bank of America All U.S. Convertible Index is a measure of the U.S. convertible market. The Bank of America Merrill Lynch VXA1 Index is a measure of investment grade U.S. convertibles.

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