The Calamos Approach to Value: An Introduction to Active Value Management

Much of Greek philosophy was concerned with understanding the universal essence and nature of time and life. The Greek philosopher Heraclitus stated "all things pass." Similarly, in value investing, one must often look for a business whose "essence" is long lasting, but whose current troubles will soon pass. However, this is a doubled-edged sword, as it is not only the bad that will pass, but also often the good. History is littered with companies whose time at the top came to "pass." Polaroid, Eastman Kodak, and General Motors are once-great, iconic companies that fell on hard times. But once a company is truly broken, it rarely fixes itself. All three companies eventually filed for bankruptcy.

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TABLE OF CONTENTS

The Calamos Value Philosophy 3

The Calamos Value Investment Process. 4

Team Structure. 6

Risk Management 7

Conclusion 8

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I. THE CALAMOS VALUE PHILOSOPHY

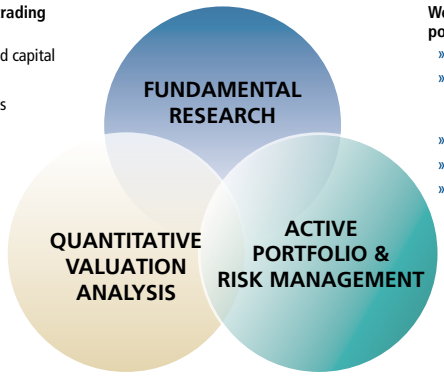
The Calamos Value team believes that superior returns can be earned over time by investing in good businesses at value prices, actively managing positions to source incremental returns and limit losses, and holding stocks only until they are appropriately valued.

The Calamos Value team seeks out companies that are not broken, just a bit battered, and seeks to own them while their stock prices reflect a view more dire than ours. A unifying theme at Calamos is that growth in cash flows drives growth in stock prices. Growth can come in two forms—secular, long-term growth and short-term cyclical or mean-reversion growth. Strong long-term secular growth companies are generally too expensive for the Calamos value discipline, and so the team focuses on misunderstood and mispriced slower-growing companies with the expectation that the stock market's negative sentiment for them will abate relatively soon. Often this means we are only temporary owners of a business, as we will own it only for so long as it is undervalued. A strong business will usually not remain misunderstood and undervalued by the stock market forever, but over time will recover and become fully valued.

INVESTMENT PHILOSOPHY

OPPORTUNISTIC VALUE INVESTING

We seek to buy good businesses trading at value prices
- High sustainable return on invested capital
- Low price/cash flow
- Catalyst for change in 6-18 months



We believe strong businesses have the potential to drive superior returns
- Understandable business model
- Growing free cash flow with sustainable profit margins and return on invested capital
- Competent corporate management
- Strong brands, high competitive barriers
- Pricing power, low-cost advantage

We look to deliver absolute returns and manage downside risk and capital loss
- Active portfolio management to source incremental returns and protect capital
- Strategies to manage macro and investment-specific risks

Annual Rate of Return Versus Total Return

The Calamos value approach focuses on annual rates of return. This differs from expected total return by the addition of a time factor. Simply, annual return is total return divided by the time in years it takes to earn that return. There are two ways to increase annual rates of return: find investments with a larger potential total return (that is, stocks that can double, triple, or the like—metaphorically, "swing for the fences") over a longer time horizon, or find investments

with a somewhat smaller potential total return (hitting singles with an occasional stealing of second base) that can be realized over a shorter time horizon.

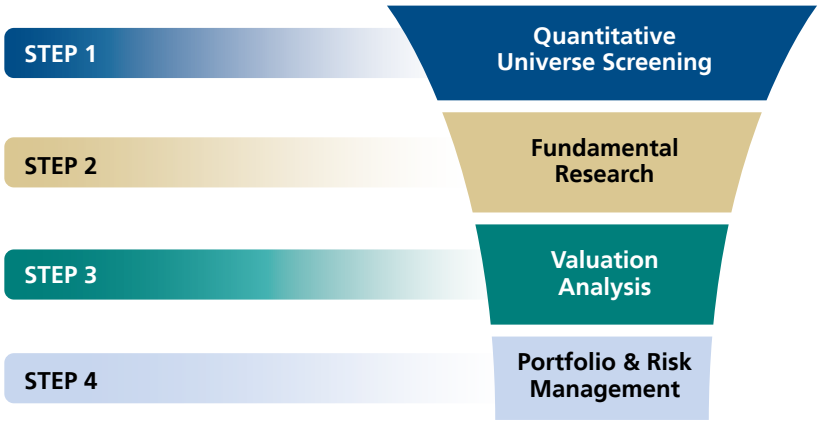
The Calamos Value team seeks to repeatedly find these temporarily mispriced securities and own them for only so long as they are undervalued, then sell and reinvest the proceeds in other undervalued securities. Because the team's goal is to own a stock for the shortest period of time necessary to realize its undervaluation, given the choice between a stock that can double in five years (about a 15% rate of return) or one that can go up 50% in the next 18 months (a 31% rate of return), the Calamos Value team would choose the 50% mover and its higher annual rate of return.

II. THE CALAMOS VALUE INVESTMENT PROCESS

Step 1. Quantitative Universe Screening

The Calamos value process starts with a quantitative scan every Sunday night, from which the team generates its "best" list for the week. The initial universe begins with companies with market capitalizations of more than $100 million, primarily U.S.-listed companies and American Depository Receipts (ADRs). The team considers all sectors and industries. The list is sorted first by market capitalization, identifying companies with market capitalizations of more than $1 billion (about 1,500 companies). Then the team uses a proprietary cash flow model to screen for companies with sustainable returns on total invested capital, excluding companies earning a return of less than 15%. This narrows the universe to about 300 to 400 good companies.

VALUE INVESTMENT PROCESS



Step 2. Fundamental Research

The remaining high-performers are sorted by price-to-sustainable cash flows. The team then analyzes those businesses on a "common sense" basis—that is, are these businesses that they would want to own all of, on a private basis, and rely upon only the cash flow from these businesses to pay the bills?

Through qualitative research, the team identifies businesses with high sustainable returns on capital that are trading for a low price relative to those sustainable cash flows. This approach favors companies with simple businesses, competent corporate management, strong brands, high competitive barriers and pricing power. The team wants businesses that are not going to become obsolete and do not require large amounts of capital reinvestment to maintain their cash flows. Such companies differ markedly from highly capital-intensive businesses such as a semiconductor manufacturer, in which huge amounts of money are invested in R&D to produce a chip that costs billions to produce, and which may only give the maker an edge over its competitors for six months or so. The team seeks to avoid these latter businesses at all costs. The team will also assess sentiment and sell-side research.

This qualitative analysis narrows the list to about 200 good operating businesses that are capable of generating the team's hurdle rate of return over time.

Step 3. Valuation Analysis

A company can be cheap for a good reason, so the team actively works to avoid "value traps." The Calamos Value team's definition of value does not always match up with traditional definitions of value, in that our team does not solely look at investments because they are cheap on a price-to-earnings or price-to-book basis. Instead, the key metric of the team's valuation analysis is price-to-cash flow, adaptive to industry.

The team establishes a price target and a catalyst that could move a company's stock price higher over the next six to 18 months. Such catalysts could include an executive change, merger or acquisition activity, improving sales and margins, sentiment or event-driven technical analysis.

On average, about 40 companies meet these criteria and are included in the portfolio.

Step 4. Portfolio and Risk Management

The team monitors holdings on a continual basis. The focus is on producing consistent results and loss mitigation, and overall diversification of sector exposures. They employ dynamic technical trading analysis for position entry and exist as well as strategies to manage macro and investment-specific risks. As a result of this approach, the team generally expects a higher level of turnover than a traditional value manager.

An Active Approach to Value

A defining characteristic of the Calamos value approach is an active focus on taking advantage of short-term volatility. When the team invests in a stock, the idea is to build an allocation

III. TEAM STRUCTURE

A dedicated value team oversees the Calamos value portfolios. As do all Calamos investment teams, the value equity team closely collaborates with the Global Co-CIOs and other senior members of the investment organization, and draws upon the resources of the firm's entire investment team.

In keeping with Calamos' long-standing culture, the Calamos Value team prizes independent thinking and questioning of "Street wisdom" regarding the near-term outlook for companies, industries and the economy. Each member of the team is responsible for specific sub-sectors, and performs in-depth fundamental research, which is supplemented by input from Wall Street, other fund managers and industry sources. The team members generate primary information and independent views on stocks to maximize the investment risk/reward profile.

In the Calamos value approach, active trading is a way to potentially enhance performance in a volatile market environment. The team closely monitors event-driven trading opportunities. Trading around core positions generates incremental returns while protecting the portfolio from sharp corrections. Additionally, our active trading discipline provides flexibility to shift assets into the most favorable risk/reward opportunities.

Moreover, we believe that as more funds outsource trading or use pre-built algorithms, traditional trading methods focused on generating absolute returns will become more valuable to funds that have the expertise to utilize them.

over time according to a highly disciplined approach. After initiating a position, the team will wait for a pullback to add to its stake. Of course, this pullback must be due to a reason the team can understand (for example, the overall market is off 10% as well, the company had an earnings miss the team believes is ephemeral, or the CEO stumbled in comments at an investor conference). In contrast, if the stock falls for a reason the team cannot discern (there isn't any real news, or the market overall is flat or up and yet the stock is off 10%), the team will sell the position. Limiting losses through actively managing and quickly selling losing positions is a key part of the Calamos value strategy.

Similarly, the team pays close attention to short-term volatility when paring positions. As a stock approaches its price target, the team will scale back, and will be out of the position when it hits the team's price target.

Risk Management

Value investing, as practiced by the Calamos Value team, is a replicable, repeatable process that attempts to minimize the loss of a significant amount of capital in any one position and have the gains from its winners be a multiple of the losses from its losing positions.

Active risk management is an integral part of this process. The Calamos Value team believes that there are many kinds of risk, and that most portfolio managers only try to control the least dangerous one for long-term investors: volatility. However, we view the real risk to investors as being permanent loss of capital.

If the relative underperformance is temporary, the team will likely maintain its position. If it is likely to continue, the team will sell its position and move on to another company with better annual rate-of-return expectations. In short, we do not want to become enamored with a company or a management team and risk becoming stock collectors.

The Calamos Value team also guards against other types of risks, such as the risk inherent in holding a properly priced security. Once the stock reaches the "right" price (the price at which it is neither undervalued nor overvalued), only two things can happen that will make money: the stock can either go higher and become overpriced or it can track the market return, which is not our goal. We believe that instead of hoping for outperformance coming from fairly valued stocks becoming overvalued, we should sell them and reinvest in other undervalued

stocks. The team may even buy back stocks sold earlier if they have fallen significantly since their sales (this happens frequently), provided the reason for the decline is clearly understood.

IV. Conclusion

As noted, the Calamos Value team prefers to be buyers of broken stocks, not broken companies. When the stocks are no longer "broken," the team no longer wants to own them. Additionally, the team is not a collector of companies. There are many great companies, but not all great companies make great investments over the short term or sometimes even long term. The Calamos value approach reflects the view that it is not enough to just buy and hold great companies to produce excellent investment returns. Instead, the goal of this active value approach is to buy stocks of great companies that are cheap on a price to sustainable free cash flow basis, and then sell them when they become fully valued.

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