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Fine-Tuning Exposure to Emerging Economies

The growth opportunity in emerging markets has been called into question in recent years, as economic expansion has slowed and equity returns have disappointed. At Calamos, we continue to believe emerging markets offer tremendous longer-term growth potential and will likely be a critical source of capital appreciation for growth-seeking investors. However, the opportunities in emerging economies reflect greater differentiation than in years past. The gaps are growing ever wider between the haves and have-nots—those economies moving forward and those retreating. In our view, investors who exercise a higher degree of selectivity and discrimination in evaluating emerging opportunities are more likely to reap larger rewards.

EMs offer a breadth of opportunity, e.g.:

- expanding middle-class consumption in China
- innovation in information technology services in India
- demand for building materials in Mexico
- high-value manufacturing services in South Korea

EMERGING MARKET LANDSCAPE

Emerging markets are often grouped together and discussed as a whole, but the economic conditions and high dispersion of returns among individual markets during recent years have repeatedly demonstrated the importance of selectivity in portfolio construction. After all, emerging markets are essentially a construct and not a truly defined region by common geography, history or culture. In short, emerging markets are not monolithic. They are thoroughly multi-dimensional. As such, investment opportunities also vary greatly and reflect many distinctions.

It seems increasingly clear that the global economy and financial markets are, for better or worse, inextricably interdependent or "coupled." This presents both challenges and opportunities to global investors. The intersection of emerging market and developed market companies and consumers is highly interwoven with actions on the part of one affecting another. Businesses, customers, employees, and various corporate functions, such as sales and R&D, emanating from any number of emerging and developed markets represent both drivers of growth and sources of competition.

Emerging economies remain key contributors to global growth as they have grown to represent approximately half of global GDP, while the rate of change has naturally moderated. While the pace of overall emerging market GDP growth still exceeds that of developed economies, it has ebbed and flowed and is converging toward the levels of more mature economies. Emerging economies may be more capable of 4% economic growth for the foreseeable future, a level that seems much more sustainable than the mid-to-high single-digit growth a decade earlier.

An emphasis on company fundamentals and "revenue mapping" helps us expand to a larger investable opportunity set and more accurately reflects global business dynamics.

INCREASING THE INVESTABLE OPPORTUNITY SET

Investing in a universe defined by the emerging market index alone may be too blunt a tool for investors. Our active approach is not content to "take what the market gives us." Instead, it asks if there is an alternative or better way to access a growth trend. In cases where local capital markets may not provide sufficient access to a targeted growth area, a broader approach may benefit potential security selection. Similarly, in situations where our analysis indicates a company's equity offers an unattractive risk-reward balance, we may seek to invest elsewhere in the capital structure with selective investments in convertible securities.

A sound investment approach aims to identify the underlying drivers of growth and its beneficiaries, no matter where the company is located. From a big-picture perspective, many emerging economies have been transitioning from export-led growth to a more balanced growth profile with a greater contribution from domestic demand and services. With this in mind, we analyze which industries will reap the benefits of this transition and, delving further, which companies are likely to be leaders and laggards in this next growth stage.

In addition to investing in emerging market-domiciled companies, our team can invest in developed market-domiciled companies generating a significant portion of revenue or invested capital in emerging markets. An emphasis on company fundamentals and "revenue mapping" helps us expand to a larger investable opportunity set and more accurately reflects global business dynamics. We believe this provides an advantage to actively select from more attractive business models and to exploit relative opportunities in stock prices and valuations.

Broadly speaking, our team may invest in:

- EM companies
- EM multinational corporations (MNCs)
- developed market MNCs
- multinational affiliates operating in EMs

Our investment process is more focused on the level of exposure to growth in emerging economies than where a company is headquartered. For example, a company based in Western Europe may actually provide more targeted access to the demand for improved power infrastructure in India relative to local companies that may be overly diversified conglomerates or private companies out of the reach of most investors.

Our team selectively invests in equity-sensitive securities, including convertible securities, as a means to participate in equity appreciation with potentially less equity downside. Because convertible securities include a fixed income component along with an option component (the right to convert into stock), a convertible may participate as the underlying stock appreciates but may also provide a cushion in the form of its bond value when the underlying stock declines. Given the historic precedent for emerging market equities to experience significant and rapid sell-offs, we believe the attributes of convertible securities represent a structural advantage relative to an all-equity portfolio.

RESEARCH SUPPORTS THE CASE FOR GEOGRAPHIC FLEXIBILITY

MSCI's 2012 paper, "Economic Exposure to Emerging Markets," concludes that there is a strong positive relationship between the amount of economic exposure of developed market companies to emerging markets and the sensitivity of their stock returns to the excess return of MSCI Emerging Markets Index versus the MSCI World Index. In short, companies generating a significant portion of revenue from emerging markets tend to have stocks that react more to movements in emerging markets than a typical company in the MSCI World Index.

Our team conducted an updated analysis of returns for the MSCI Emerging Markets Index and the MSCI World with EM Exposure Index (representative of considerable business activity in EMs that is conducted by DM companies). Our analysis supported the findings of MSCI. Specifically, over a 10-year period ending in January 2016, the MSCI World with EM Exposure Index demonstrated a 0.80 correlation of returns to the MSCI Emerging Markets Index. This compares to a significantly lower 0.48 return correlation of developed markets overall to emerging markets, as reflected in the MSCI World Index and MSCI Emerging Markets Index. Indeed, economic exposure has significant influence on equity returns and is a vital area of analysis among the global opportunity set.

We have long held that our holdings in affiliates of large multinational corporations have supported our risk-managed approach by combining the benefits of improved transparency and governance with the resources of multinational corporate ownership.

A second paper published in 2012 by Professor Martijn Cremers[1] supports this view. Cremers found that publicly traded emerging market affiliates of large multinational corporations outperformed both their local stock market and the wider emerging markets over a 14-year period through June 2011. In addition to better returns, the stocks of the affiliates demonstrated lower volatility, especially lower downside volatility. Cremers cites improved corporate governance and a stabilizing role of the parent companies as contributing factors to outperformance.

[1]Cremers, Martijn, Emerging Market Outperformance: Public-Traded Affiliates of Multinational Corporations (February 23, 2012).

We expect secular themes to drive growth and create investment opportunities.

- Information and entertainment, anywhere/anytime
- Global demographic shifts, growing global middle class
- Automation and manufacturing efficiencies
- Proliferation of data and accessibility of analytics
- Advances in nanotech, biotech, and genetics
- Global infrastructure build
- Financial disintermediation
- China's global ambitions

IDENTIFYING OPPORTUNITIES THROUGH A THEMATIC LENS

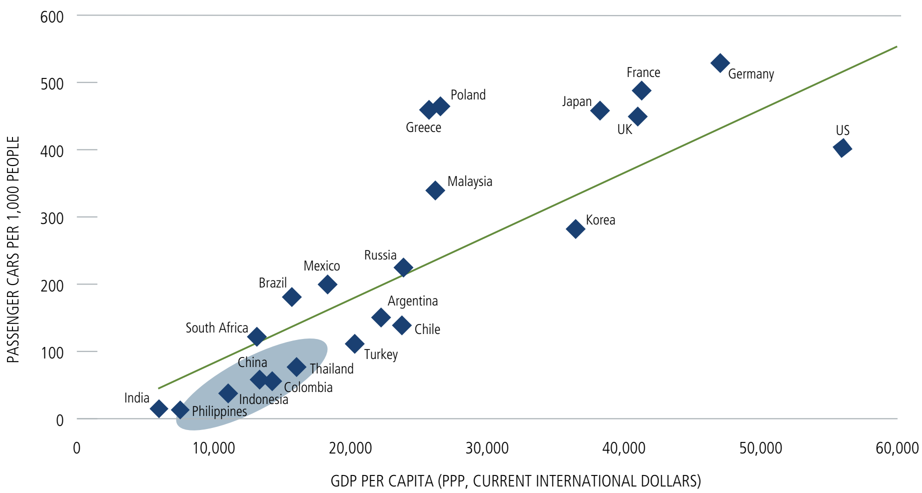
Another critical component to our investment approach and process in fine-tuning exposures is identifying and investing along secular growth themes. Secular themes are long-term trends that can provide a tailwind for growth and return-on-invested capital for years to come. There are winners and losers in terms of participation in a secular theme and the outcomes have important implications for returns on invested capital and, ultimately, investment performance.

From a thematic perspective, the growth of middle-class consumption in emerging economies is a significant emphasis for our investment team and a key aspect of security selection. As of 2010, over 1.8 billion individuals comprised the global middle class, with approximately half of these residing in emerging markets (OECD, 2010). Even more important to us as growth investors is the projected increase of this global populace to an estimated 3.2 billion people in 2020 and estimates that consumption will leap forward, from approximately $12 trillion in 2010 to $30 trillion in 2025 (OECD, McKinsey & Co.). As incomes rise and middle-class households proliferate, this spurs a transition from essential items to more discretionary goods and services. In our analysis, we are seeing clear effects of this transition in categories including travel and education services, branded beverages and foods, apparel and accessories, and automobiles.

EM Demand Example 1: Autos. Demand trends in autos have been a plentiful source of growth opportunities despite the multi-year economic malaise that has plagued many emerging economies. Emerging economies have seen strong tailwinds in demand for autos as incomes rise, local production reduces costs, and increased credit availability makes the purchase more affordable to more consumers (Figure 1). Auto manufacturers are the most direct beneficiaries, but demand for parts, commodities, services, and travel broaden the economic impact.

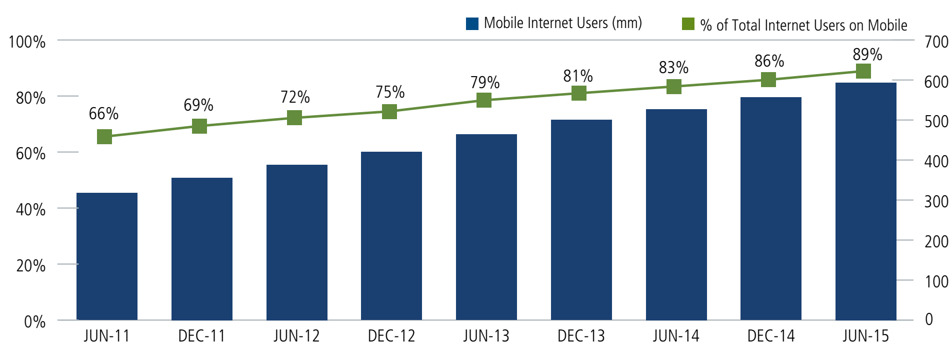
EM Demand Example 2: Information and connectivity. The demand for information anytime and anywhere is contributing to rapid innovation in connectivity and mobility solutions globally. Emerging markets have experienced explosive growth in the ownership of smartphones and related devices, and the demand trend has evolved toward more opportunities in software and the app-enabled economy. China's mobile internet adoption has increased approximately 20% in the past three years (Figure 2) and produced a wave of innovation in e-commerce, mobile payments, gaming and social media, among other areas.

FIGURE 1. VEHICLE PENETRATION RATES HAVE HISTORICALLY INCREASED AS GDP PER CAPITA INCREASES



Source: World Bank, using data from International Road Federation and World Road Statistics and data files; and IMF World Economic Outlook database. GDP per capita (PPP) data is represented by 2015 estimated data. Passenger cars per 1,000 people is represented by the most recent data available per country in World Bank's world development indicators standard database.

FIGURE 2. CHINA MOBILE ADOPTION



Source: CNNIC's 36th Annual Survey.

RISK-FOCUSED IMPERATIVE

Event risk and political risk exert a significant influence on emerging market volatility and price performance. Examples are well documented and include the impacts of China's yuan devaluation and the knock-on effects on global markets over the past several months, the Russia-Ukraine conflict in 2014, the 2013 "Taper Tantrum", multiple European debt crisis flare-ups, and the Arab Spring in 2011—to cite only a handful.

These episodic sell-offs seem to occur every 12 to 18 months and have served as "stress tests" for our risk-managed approach to emerging market equities. Additionally, the flow of funds into emerging markets has historically contributed to significant volatility. Cross-border capital

Our team believes an investment approach targeting exposure to emerging economies, and not simply the emerging capital markets, has the potential to produce a more compelling risk-adjusted return across a complete market cycle.

flows, often referred to as "hot money," can have a disproportionate impact on markets with less liquidity, lower levels of regulation, and considerably smaller total market value.

These sources of volatility are key reasons why emerging markets have often been considered a shorter-term tactical position. Some strategists have gone so far as to question the validity of emerging markets as an asset class. In some respects, this degree of skepticism is healthy and may serve to shake out some of the weak hands in EMs. At a minimum, the volatile and sub-par returns in emerging markets may prompt asset allocators to revisit the risk and return trade-off and evaluate a range of potential investment solutions.

It is an understatement to say the market cycle since the financial crisis has not been kind to emerging market investors. Figure 3 shows the performance of emerging market equities, as represented by the MSCI Emerging Markets Index, versus developed markets (MSCI World Index and MSCI World ex-U.S. Index). In the 5-year period, emerging market equities significantly underperformed returns in developed market equities, while also challenging investors with higher volatility. From a much longer-term perspective (since the 1988 inception of the MSCI Emerging Markets Index), emerging markets have significantly outpaced the returns in developed markets.

FIGURE 3. HISTORIC RISK/RETURN PROFILE OF EMERGING VS. DEVELOPED MARKETS

	5-YEAR		10-YEAR		SINCE INCEPTION (1988)	
	ANNUAL RETURN	STANDARD DEVIATION	ANNUAL RETURN	STANDARD DEVIATION	ANNUAL RETURN	STANDARD DEVIATION
MSCI Emerging Markets Index	-4.47%	17.78%	3.95%	23.60%	10.51%	23.23%
MSCI World Index	8.19	12.78	5.56	16.36	7.54	14.95
MSCI World ex-U.S. Index	3.28	14.77	3.41	18.46	5.59	17.00

Source: Morningstar. **Past performance is no guarantee of future results.** Data shown in U.S. dollars through 12/31/2015.

We believe our risk-managed investment approach is well equipped to address the risks inherent in emerging markets. We seek to stair-step higher during gains in emerging markets while preserving capital during market downturns, targeting a superior return with reduced risk characteristics over a complete market cycle. We believe our approach offers structural advantages versus portfolios that invest exclusively in emerging market equities. By providing targeted access to emerging markets revenue, earnings, and consumption growth, we believe we can access growth while potentially reducing the risks posed by capital flows and sentiment change.

CALAMOS EMERGING MARKETS PHILOSOPHY: POINTS OF DIFFERENTIATION

- Our investable universe includes EM-domiciled companies and developed market-domiciled companies that generate a significant portion (generally 20% or more) of revenue or invested capital in EMs.
- Applying decades of capital structure research to security selection, the Calamos investment team selectively invests in equity-sensitive securities, including convertible securities, to participate in equity appreciation and potentially provide downside protection.
- An emphasis on company fundamentals, and what we refer to as "revenue mapping," more accurately reflects business dynamics.
- Our team gives considerable attention to secular growth themes and how to access these themes across sectors and industries, as well as across geographies.

CONCLUSION

In our view, EM is not a one-size fits all investment solution, nor is it best considered as a broad macro bet on global growth dynamics. It is our belief that emerging economies remain well-positioned to access many of the dominant growth trends of the next decade. Enthusiasm for emerging market assets has diminished substantially in recent years, as quite clearly reflected in investor positioning, capital flows, and valuation. It is certainly possible, however, that with the benefit of hindsight, the rather widespread pessimism of today may eventually appear as excessive as the widespread exuberance in 2006-2007.

Given the longer-term population growth dynamics and potential gains in income and productivity, we believe emerging market economic growth will be a critical contributor to overall global growth in the coming decade. As multiple studies have established, however, higher economic growth does not simply translate to excess returns for equities. Selectivity will continue to be critical in emerging markets as the impacts of policy reforms, twin deficits, commodity prices, debt burdens, and secular growth drivers translate to a widening gap between the haves and have-nots.

Our team believes an investment approach targeting exposure to emerging economies, and not simply the emerging capital markets, has the potential to produce a more compelling risk-adjusted return across a complete market cycle. As the emerging economies evolve, so too will secular themes develop and well-positioned companies benefit. We believe our risk-managed investment approach and a portfolio utilizing a wider opportunity set, with geographic and security-type flexibility, will be better able to target emerging opportunities while providing a smoother return profile. In summary, we believe ours is a more rational and structurally advantaged approach to access investment opportunities in emerging economies.

For additional commentary from our investment team, visit our Investment Team Blog at www.calamos.com/blog and commentary library at www.calamos.com/insights.

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. The MSCI World ex-U.S. Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America (excluding the U.S.), Europe and Asia Pacific regions. The MSCI Emerging Markets Index is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities. The MSCI World with Emerging Markets (EM) Exposure Index is derived from the MSCI World Index and includes the top-ranked constituents with the highest proportion of revenues derived from EM countries.

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