Phineus Long/Short Strategy

CALAMOS INVESTMENTS

Market Overview

Buoyed by robust economic growth, healthy corporate profits and extraordinary consumer and small business confidence, the S&P 500 Index returned 7.71% for Q3 2018. Led predominantly by its U.S. components, the MSCI World Index gained 5.10% for the period.

A strong U.S. economy drove U.S. stocks and Treasury yields higher, and U.S. equities again outperformed their global peers. In September, U.S. consumer confidence hit its highest level in 18 years, while small business confidence attained levels not seen in nearly half a century. Employment markets firmed further, with initial jobless claims declining to the lowest level since 1969 and reported wage growth edging higher. Retail sales grew over 7% year-over-year and put the spotlight on the extraordinary health of the U.S. consumer.

This vigorous backdrop prompted the Fed to raise its benchmark fed funds rate by another quarter percentage point to a range of 2.00% to 2.25% in September. Globally, the U.S. remains the stark outlier: the only major economic region that is decisively moving away from the monetary super stimulus of the post-2008 setting. In contrast, the European Central Bank maintains that interest rates will not be increased until the summer of 2019, as economic activity remains muted in that region. We regard monetary normalization as a key advantage for U.S. financial assets.

The widely watched U.S. yield curve, or the spread between 10-year and 2-year Treasury yields, has flattened to approximately 25 basis points. Prevailing trends suggest an inversion in the curve is possible by early 2019. That said, a near-inversion is not an inversion and has little forecasting value. A narrow spread can be maintained for some time: in the 1990s, today's yield curve pattern extended for years without negative implications for economic growth. While many remain intent on forecasting the inversion process, we await an actual inversion and believe the U.S. economic narrative of "stronger for longer" will extend through 2019.

The U.S. dollar has continued to strengthen, implying that emerging markets (EM) are vulnerable due to the prevalence of high USD corporate borrowing. A strong dollar constrains what many authorities such as Beijing can do on the monetary easing front. For example, Chinese nonfinancial corporates are the EM world's single largest issuer of U.S. dollar-denominated debt. While higher U.S. interest rates are appropriate for the more normalized U.S. setting, they are problematic for much of the EM world because insolvency risk has merely been suppressed, not properly resolved.

As of mid-October, it appears the NAFTA discussions (aka the U.S.-Mexico-Canada Agreement or USMCA) concluded with remarkable concessions from both Canada and Mexico. The target of renegotiation was structural reform of auto manufacturing, where the required North American content will rise to 75% versus the former level of less than 50%, with more of this content accruing to the benefit of U.S. workers. The terms that prevent Canada and Mexico

FIGURE 1. PHINEUS LONG/SHORT STRATEGY RETURNS

	QTR ENDING 9/30/18	1-YEAR	3-YEAR	5-YEAR	10-YEAR	SINCE INCEPTION (6/1/02)
Phineus Long/Short Composite						
Gross of Fees	-1.51%	1.92%	7.41%	7.56%	11.41%	13.22%
Net of Fees	-1.82	0.66	6.04	6.09	9.83	11.60
MSCI World Index	5.10	11.84	14.18	9.89	9.18	7.77
S&P 500 Index	7.71	17.91	17.31	13.95	11.97	8.52
HFRI Equity Hedge (Total) Index	0.68	5.28	7.39	5.14	5.19	5.28

Source: Calamos Advisors LLC
Past performance is no guarantee of future results.
Data as of 9/30/18.

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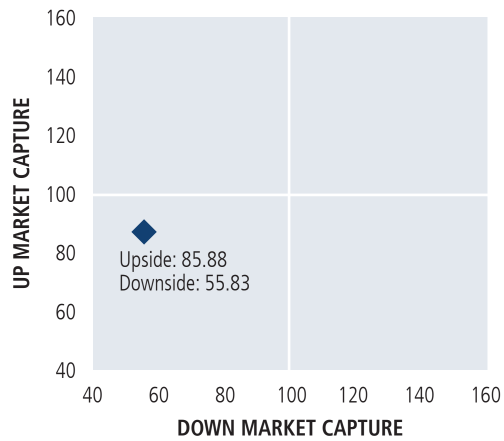
FIGURE 2. SINCE INCEPTION RISK/REWARD CHARACTERISTICS

	CALAMOS PHINEUS LONG/SHORT COMPOSITE	MSCI WORLD INDEX
Annualized Alpha	7.83%	N/A
Beta	0.72	1.00
Standard Deviation	16.49%	14.71%
Information Ratio	0.41	N/A
Sharpe Ratio	0.73	0.44
Sortino Ratio	1.36	0.63
Upside Semivariance	17.55%	9.77%
Downside Semivariance	6.32%	8.69%

Past performance does not guarantee or indicate future results.
Source: Calamos Advisors LLC

FIGURE 3. SINCE INCEPTION UP/DOWN CAPTURE VS. MSCI WORLD INDEX



Past performance does not guarantee or indicate future results. 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.
Source: Calamos Advisors LLC
Data as of 9/30/18.

from doing any side deals with China reflect President Trump's agenda of undermining global supply chains in favor of regional supply chains. Most adjustments were detrimental for Canada and Mexico relative to the original NAFTA, accentuating this "America first" philosophy into trade deals.

As a general rule, Trump's "trade wars" are a negotiating tactic. China is the major exception to this. China is more problematic because Trump seeks to undermine the supply structure on which a good amount of China's importance in global trade depends. More generally, Washington no longer views China as a small, emerging economy but as a strategic rival. For many, China epitomizes the frustration with a multilateral order in which constraints and responsibilities seem to apply only to the U.S.

As China struggles with its extended credit cycle and declining capital flows, this trade and monetary squeeze in the form of higher U.S. interest rates is a challenge. The rebalancing of trade in favor of the U.S. and at the expense of growth abroad will remain a feature of the investment setting for many years. The dynamic that allows Trump to get his way in these negotiations can be summarized by a simple truth: the U.S. is still the world's only indispensable economy led by the U.S. consumer.

The year to date can be characterized as a rolling bear market for most countries except the U.S. However, the same can be said for the U.S. outside of large-cap tech. Without positioning in technology, gains have been hard to come by. The portfolio's focus throughout the year has been capital preservation, which has been reflected in its U.S. versus non-U.S. exposure, the index hedging activities and the composition of the long portfolio. Peak multiples for this bull market occurred in January: equities have been de-rated since then despite healthy corporate fundamentals.

Today's controversy surrounds the outlook for the U.S. economy, which we view as solid through 2019 and possibly 2020. Indeed, the outstanding feature of 2018 is the divergence of growth and financial conditions between the U.S. and the rest of world. This economic strength is a problem for equities because the monetary tide in the West is turning. Developed central banks are convinced that deflation risk is fading: the interests of investors are no longer aligned with them. Markets can adjust to this new setting, but a critical variable is the speed of such change.

This demonstration of stronger U.S. growth is creating the realization that the Federal Reserve will pursue its agenda of monetary normalization until the U.S. stock market tells it to stop. We have characterized the outlook for equities as a race between rising

All portfolio positioning and sector information is for a representative portfolio. Please see the last page for additional information.

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FIGURE 4. SECTOR WEIGHTINGS (%)

	LONG	SHORT	GROSS	NET	MSCI WORLD INDEX
Consumer Discretionary	15.8	0.0	15.8	15.8	12.6
Consumer Staples	0.1	0.0	0.1	0.1	8.1
Energy	0.0	0.0	0.0	0.0	6.5
Financials	42.8	-0.1	42.9	42.7	16.3
Health Care	9.7	-3.4	13.0	6.3	12.9
Industrials	7.5	-0.3	7.8	7.3	11.3
Information Technology	13.1	-6.4	19.4	6.7	19.1
Materials	1.6	0.0	1.6	1.6	4.7
Real Estate	0.0	0.0	0.0	0.0	2.9
Telecom Services	0.0	0.0	0.0	0.0	2.6
Utilities	0.0	0.0	0.0	0.0	2.9
Other	0.7	-33.4	34.1	-32.7	0.0
TOTAL	**91.3**	**-43.5**	**134.8**	**47.8**	**100.0**

Numbers may not add up due to rounding. Sector weightings based on percentage of total account and are subject to change. Sector weightings exclude cash or cash equivalents. Source: Calamos Advisors LLC. Data as of 9/30/18.

FIGURE 5. REGIONAL ALLOCATION (%)

	LONG	SHORT	GROSS	NET	MSCI WORLD INDEX
North America	86.1	-43.5	129.6	42.6	64.1
Europe	5.2	0.0	5.2	5.2	22.9
Asia/Pacific	0.0	0.0	0.0	0.0	12.6
Middle East/Africa	0.0	0.0	0.0	0.0	0.2
Latin America	0.0	0.0	0.0	0.0	0.1
Caribbean	0.0	0.0	0.0	0.0	0.1
TOTAL	**91.3**	**-43.5**	**134.8**	**47.8**	**100.0**

Regional weightings are based on security's region of domicile. Numbers may not add up due to rounding. Source: Calamos Advisors LLC. Data as of 9/30/18.

interest rates and robust corporate fundamentals. Only in the U.S. are returns for authentic risk assets still positive in 2018. The obvious question is: When will the disruptive effects of strong late-cycle growth finally extend to U.S. stocks as well? In particular, the downgrading of the U.S. growth leaders should define when "late-cycle" finally translates to "end-cycle."

Positioning and Portfolio Changes

Our approach in 2018 has been one of caution and patience. This has proven fortuitous as general equity losses have accumulated as the year has progressed. As we write this note in October, the bear trend has become more substantial, more geographically widespread and nastier with respect to individual stocks than the major U.S. benchmarks. Its latest feature is that the damage is extending (at last) to the former leaders: U.S. mega-cap growth technology.

We have been selective in the large-cap U.S. growth space since late 2017, partly due to our forecast reversal of "growth momentum" in the context of higher long-term interest rates. Another reason was the overcrowding or excess positioning that is typical of a late stage bull market. Finally, many passive strategies that have impacted equity behavior since 2016 appeared ripe for disruption. With money flows focused on a few mega-cap leaders, our lack of exposure in high-profile names like Amazon and Apple has impacted, positively and negatively, the portfolio's 2018 performance.

One example of this selectivity has been the short position across the semiconductor industry. Here, we anticipate ebbing rates of growth in the context of inflated long-term expectations based on the unsustainable cloud build-out and the crypto-currency craze, which together have distorted the demand/supply balance for the industry. Elsewhere, the portfolio took profits and exited rapidly growing, but earlier-stage businesses such as Workday and Zendesk. Our remaining technology positions lean toward secular names, such as Google and Facebook, which can be supported with traditional valuation metrics.

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The counterpart of this selectivity was the overweight in financials, where valuations make sense and fundamentals are benefiting from the tailwind of higher rates. This positioning envisaged a gradual market transition from higher momentum growth to domestic cyclical and non-cyclical equity. Financials should be buoyed by rising rates, steady loan growth and benign credit quality. The critical assumption remains the end of deflation risk in Western economies, underpinned by a sound U.S. consumer. As valuations suggest, this is somewhat contrarian and offers insight into our year-to-date attribution.

We slightly increased our exposure to certain areas of industrials. The key with industrials is to avoid businesses exposed to the very different economic landscape abroad. We believe industrials that are U.S.-biased with an emphasis on quality and late-cycle businesses will benefit accordingly. The portfolio reduced its exposure to United Continental Holdings after strong relative performance, but maintains the long position in Delta Air Lines.

We have maintained a presence in health care, preferring diversified companies such as Johnson & Johnson and Laboratory Corporation of America (LabCorp) rather than traditional pharmaceuticals. We believe they offer more upside for the same types of risk. Drug pricing remains vulnerable to a variety of political clouds that will come more into focus through the November midterm elections. The industry will struggle to emerge unscathed from the secular spending pressures that are an outcome of demographic realities. We view the group as a defensive rather than a genuine growth class.

We have exited much of our long exposure in consumer staples. Many of these stocks have performed well of late as investors have sought more defensive positioning, yet corporate fundamentals remain structurally unattractive. The portfolio remains selective here, focused on more discretionary names such as McDonald's, which is in the middle innings of a multi-year turnaround as it shifts to an asset-light franchise model. We expect a more predictable earnings stream and accelerated free cash flow growth.

Wal-Mart is a new long position, which is benefiting from the revival of the U.S. middle-class consumer. Many of the macro developments in the U.S. argue for structural improvement in their core customer base, which should translate into stronger same store sales. In Europe, the portfolio is long Adidas AG, the footwear competitor to Nike. Adidas is valued in line with U.S. consumer staples businesses, but with a higher growth outlook led by distribution gains in North America.

The divergence of U.S. versus non-U.S. equities has been extreme in 2018, but we regard this as fundamentally driven. The portfolio has less than 10% of its long portfolio outside the U.S. And within the U.S., we are sensitive to any overseas exposure, particularly Asian demand or the global producer industries. With respect to the latter, for example, the portfolio continues to avoid the energy sector.

We are not succumbing to the argument that EM equities must be attractive because they have declined so much. The return of credit risk implies an ongoing monetary squeeze for the emerging economies, which remain the weakest links. Investors have finally recognized that the China-U.S. relationship has entered a more antagonistic phase. We may be witnessing the emergence of a risk premium attached to the Pacific growth space.

In September, the portfolio closed down its shorts in the EM space on the view that some tactical bounce was overdue. Like much of Europe, however, the EM world requires a much more inflationary investment cycle to outperform. We are simply not there yet.

Europe remains a sorry and sad affair: a multiplicity of political problems. Longer term, we expect the EU will gradually splinter, and thus political uncertainty could weigh on growth for years. The silver lining is that investor expectations for Europe have been downgraded substantially and the European economy is no longer delivering negative surprises. The risk here is largely in small caps, which is Europe's equivalent of the U.S. growth leaders, due to their valuation premium amid late-cycle risks.

The hope for Europe is that its political classes steal a page from the Trump playbook. There is enormous scope for fiscal initiatives of the kind that have re-energized the U.S. economy. Unfortunately, the political structure of the European Union is biased in favor of the debtor, not the creditor countries. This shift will take time, although populist governments are starting to challenge economic orthodoxy in Europe. The exception to this quagmire could be the UK, which we expect to emerge as a major outperformer after Brexit. We see Brexit as symbolic of the shift from austerity to fiscal stimulus—the question is when?

We prefer the optionality of the depressed financials in Europe relative to its many cyclical compartments. This is a contrary value play, as European banks are clear proof of European malaise: bloated regulation, low profitability and the inability to consolidate. That said, the upward pressure on euro interest rates should return as soon as investor appetite for risk revives. The portfolio has a handful of long positions (<5% in aggregate) in select, lowly valued, high dividend-paying financials that have limited downside.

The message of 2018 resounds: we are not just witnessing more of the same in the equity world. The portfolio's approach to protection has reflected this and we actively manage a hedge on both the S&P 500 and the NASDAQ Composite Indices, taking these up or down on a tactical basis. Into the quarter's end, the portfolio was well hedged for fundamental and technical reasons. Simply put, October can be a scary month for equities and—with risk premiums depressed—the cost of protection appeared unduly cheap for a late-cycle setting.

Outlook

The equity bull market is fatigued because the monetary tide in the West is turning. This is confusing to investors who have long relied upon central banks to support economic growth. Instead, financial asset prices are deflating because the paucity of economic growth is no longer the problem. The long path to higher interest rates seems assured, and financial markets face the pain of this adjustment: the monetary drugs are slowly being withdrawn by the central bankers.

This has been the year of fiscally enhanced, underestimated, late-cycle American expansion. Because we believe much of this strength is sustainable, the significance of the disruptive divergence between U.S. and non-U.S. activity continues to be underestimated. While many view this robustness as a sort of a "sugar high," or the consequence of financial engineering due to the Tax Cuts and Jobs Act, we suspect the U.S. has entered a new investment cycle led by capital spending and the ramifications of trade conflict.

The controversy starts with the macroeconomic repercussions of the tax reform that was signed into law last December. Such a massive transfer of resources from the public to private sector must trigger some kind of investment upswing. These tax cuts are occurring in the context of deregulation that has encouraged the highest levels of confidence on record among U.S. small businesses. By boosting corporate profitability and extending the duration of corporate credit, fiscal initiatives have pushed out the cyclical risks for what is widely viewed as an aged expansion.

All of this suggests that the path to slower U.S. growth will not occur spontaneously, if at all in 2019. One caveat to this "stronger for longer" narrative could be weaker external demand due to slower growth of world output and trade. To some degree, domestic U.S. demand should be impacted by rising costs and more restrictive monetary policy. But any slowdown in 2019 or 2020 will almost certainly be the consequence, not the cause of financial disruption. In our view, 2019 could well be good for Main Street, but much more problematic for Wall Street.

As the turmoil across global markets advances, it is striking that developed debt and forex markets have remained in a benign state. This absence of any flight to the debt markets underlines what is unique about today's turmoil: investors are no longer being rescued by the major central banks, which no longer fear deflation. Instead, we are witnessing the beginning of a gradual de-rating in financial prices that is the logical extension of the end of monetary super-stimulus and its corollary, the subsidization of capital.

This peak of financial prices across global markets commenced in January. To varying degrees, it has been disguised by robust U.S. corporate profits and the parabolic outperformance of U.S. growth stocks. Only as the bear market has extended to these former leaders has the true nature of this new paradigm appeared. Credit risk in many parts of the world has been camouflaged by a decade of financial repression.

Equity markets are adjusting to a world of less capital subsidization, higher interest rates and higher labor costs. What is confusing for many is that the U.S. engine of profitability may well motor through much of 2019, if not 2020.

The politics of trade are reinforcing these shifts. The end of the investment boom in emerging markets implies diminished profitability on several fronts, although the U.S. revival under Trump is offsetting part of this. Capital flows are returning to the U.S. and contributing to the revival of capital spending and long-term investment. As long as the U.S. economy enjoys the "stronger for longer" narrative, the bear market in financial prices is neither a major financial crisis nor a significant recession in the major Western economies.

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Our forecast for equities can be described as a valuation reset rather than the emergence of a fundamental economic or earnings dislocation. From the peaks of buying frenzy in January, we see a total decline of 20% to 25% into the eventual trough much later in 2019. For now, equities can enjoy some respite as the uncertainty of U.S. politics is calmed after the November midterm elections. This will be temporary, but consistent with ongoing convulsions as the major economies end their overreliance on the monetary opioids.

Contrary to the expectations of many (although not us), the S&P 500 has been the best performing equity market. The underpinning has been extraordinary corporate earnings, which are on track for calendar gains of ~20%. While half of this gain is tax-related, the remainder is organic: the outcome of a strong domestic economy. With fiscal stimulus likely to be as stimulative in 2019 as in 2018, we see further profit growth of 10% in the coming year.

Turning to asset allocation, we believe investors should favor countries and regions that are not overly dependent upon monetary super-stimulus. Quantitative Easing (QE) is the monetary equivalent of an opioid, which central banks have prescribed for far too long. Artificially low interest rates depress productivity, and thus depress economic growth. The U.S. is unique in its aggressive use of fiscal initiatives to end monetary super-stimulus, thereby exiting the long shadow of the "New Normal."

We are equally wary of those countries that are overcommitted to producer (as opposed to consumer) assets, which are vulnerable to the reversal of globalization. We anticipate a long period when globalization is restricted, regardless of which party assumes control in Washington. All of this implies the leadership of U.S. assets is as much structural as cyclical in nature. It implies the U.S. consumer will be a source of refuge in the next downturn.

The remarkable divergence between U.S. and non-U.S. markets may be just beginning. This is a controversial view, as many want to believe that the dismal performance abroad must soon translate into buying opportunities. One of the simplest ways to make money is to identify the leadership asset and "stick with it," which has been true for growth versus value styles since 2008. Common sense argues that this year's U.S. outperformance is extended, but we envisage many years where the U.S. economy stands alone as an island of relative prosperity.

Amid all of today's cautionary signs, the equity bull market in America is not dead yet. Monetary normalization is likely to pause in the coming quarter, allowing the S&P 500 one more assault on the 3000 level. The Fed still has considerable flexibility because inflation expectations in the U.S. remain well anchored. Not until wage pressures move sharply higher, possibly by mid-2019, will the Fed confront a genuine dilemma. Markets and economies are slowly anticipating this new setting, but the critical unknown for 2019 will be the speed of such changes.

It is worth remembering that tightening monetary policy always brings fears of "being late-cycle." The silver lining is that looser fiscal and regulatory policy at this stage, despite higher interest rates, could create the opportunity for a "soft landing" for much of the world. Of course, this must be well executed and perhaps includes a Fed pause after its rate hike in December. But any shift in the global mood away from austerity would be notable and revive investor appetite for equities.

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Calamos Advisors LLC
2020 Calamos Court
Naperville, IL 60563-2787
Attn: Compliance Officer

CALAMOS® INVESTMENTS

Calamos Advisors LLC
2020 Calamos Court | Naperville, IL 60563-2787
800.582.6959 | www.calamos.com/institutional

Calamos Investments LLP
62 Threadneedle Street | London, EC2R 8HP, UK
Tel: +44 (0)20 3744 7010 | www.calamos.com

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