# Convertible Arbitrage 101

## Objective

Convertible arbitrage is designed to enhance income and to hedge (or reduce) equity market risk while still providing the potential for upside returns through an asymmetric risk/reward profile.


## How it works

Convertible arbitrage involves purchasing a mispriced convertible bond (long position) and simultaneously short-selling a calculated number of shares of the stock. As the manager waits for the prices to converge, the portfolio is insulated from price movements of the underlying stock. Using this technique, a manager seeks to enhance income and to hedge (or reduce) equity market risk.

## Potential benefits

*Mitigate volatility.* Convertible arbitrage strategies can help mitigate the potential impact of equity market volatility. Consider a hypothetical scenario wherein a convertible bond declines in value. Typically, the underlying common stock would also decline. This would benefit a manager who had shorted the stock, offsetting the decline in the convertible.

*Generate returns.* Convertible arbitrage can generate returns from many sources, including:

1. Convertible yield advantage: Income from coupons or dividends from convertible bonds
2. Short interest credit: Potential income from rebate of the portion of interest charged by the lender to the short seller on short stock positions
3. Capital appreciation from undervalued securities
4. Rebalancing/trading (see next page for a closer look at gamma trading)

**Convertible Arbitrage 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 portfolio's increased liability on any outstanding short position would, in whole or in part, reduce this gain. Convertible securities entail interest rate risk and default risk.

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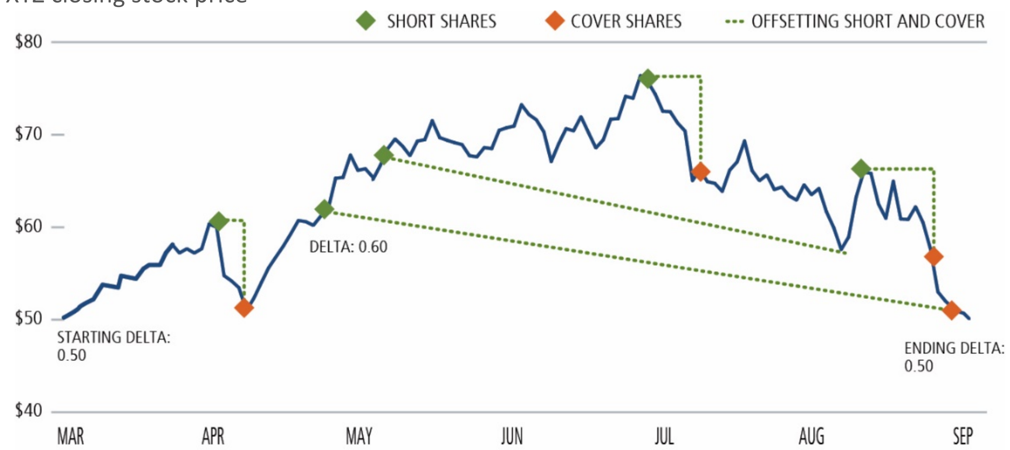
## A closer look at convertible arbitrage gamma trading

- Market volatility can provide opportunities to profit through what is referred to as gamma trading.
- A manager buys convertible bonds and sell short shares of the underlying stock as a hedge. If the stock rises, they will lose money on the shares they are short, but will make money on the bonds they own as the bonds appreciate in value.
- As the stock price changes, the manager adjusts their hedge and shorts or covers shares. As a result, they are mechanically buying as prices fall and selling as prices rise. The more volatile the stock, the more opportunities there are to buy low and sell high.

### Gamma Trading Hypothetical

XYZ closing stock price




Source: Calamos Investments. The above example is not meant to represent the performance of any given security. It is a hypothetical illustration of general investment themes.

## Convertible Bonds: An Overview

- Convertible bonds are securities that can be converted into a predetermined number of shares.
- Like fixed income securities, convertibles provide income through coupons and have seniority in the capital structure over equities. As a result, the prices of convertible securities tend to fall less than underlying equities on the downside (and rise less on the upside). This is a non-linear relationship that can be potentially exploited.
- In convertible arbitrage, convertible securities are purchased primarily and equities are sold short. The amount of shares sold short is calculated with the aim of making the equity and convertible holdings largely offset each other when the equity price moves up or down.

**For more information, please visit www.calamos.com or contact us at 800.582.6959.**



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