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Convertible Securities Offer Many Benefits—Including as a Hedge Against Inflation

KEY POINTS

Convertible securities can provide a hedge against rising inflation and long-term interest rates, while also providing lower-volatility stock market participation.

Capitalizing on the unique structural features of convertibles requires active management.

Calamos has provided innovative convertible investment solutions since the 1970s, including strategies to enhance fixed income allocations.

Calamos U.S. Convertible Strategy may help investors resist the temptation to make interest rate or market timing calls.

Since the 1970s, we have used convertible securities to help investors successfully navigate a variety of market and economic risks. Stock market volatility is one of the most pervasive risks investors face, and it can be especially frustrating due to its many causes. **In the face of unprecedented and unexpected events—such as the global spread of a new coronavirus—markets often sell off with little warning.** More commonly, market volatility results from political unknowns, geopolitical pressures or company-specific news. The coming year is no different, and we expect markets to remain choppy through the current U.S. election cycle despite favorable economic tailwinds.

There's another risk investors should pay close attention to in 2020: the potential for higher long-term interest rates, due to inflation or geopolitical events. Inflation pressures increase as the economy grows at a faster rate, with wage growth among the important contributing factors. Geopolitics can also sow the seeds of inflation—for example, a geopolitical event can stoke rising oil prices, in turn pushing up costs across the economy.

The Fed can play a part as well, either by pumping money into the economy (as it has been doing), which leads to a run up in asset prices, or by not hiking short-term rates fast enough to cool the economy and markets. Importantly, the Fed has recently indicated that it may let inflation run a bit hotter over the next couple of quarters without stepping in.

We certainly aren't calling for runaway inflation that brings the U.S. economy to a halt, but even a modest rise in inflation can drive long-term rates higher. Inflation can also ramp up quickly. Traditional fixed income investments—such as Treasury bonds—are especially vulnerable.

Convertible securities can enhance a fixed income allocation by providing a hedge against a rising interest-rate environment. Bonds tend to lose value in an environment of rising interest rates. However, convertible returns have tended to more closely reflect equity returns than bond returns when long-term interest rates rise. As we will show in the pages that follow, our active approach has consistently capitalized on this opportunity.

Convertibles are able to provide a hedge against changing interest rates because of their unique structural features, which combine attributes of stocks and bonds. Like stocks, convertibles typically offer upside appreciation in rising equity markets. Like fixed income securities, they provide income and can mitigate exposure to downside in the stock market. **While convertibles are influenced to a degree by interest rate fluctuations, they also are affected by the price movements of their underlying stocks, and this “equity sensitivity” historically has helped soften the negative effect of rising interest rates.**

With Active Management, Convertibles Can Address Specific Goals

Convertible securities are complex, and the characteristics of an individual convertible security can change over time. At certain points, a convertible may behave more like a stock, at other points, more like a bond. For example, the more a convertible's price is determined by the value of its underlying equities, the less likely it is to be influenced by changing interest rates. However, too much equity sensitivity may expose a convertible security to drawdowns in the stock market.

It is not simply the inclusion of the convertible that positions us to achieve a client's specific investment objective. Convertibles must be actively managed to ensure that a portfolio reflects the desired level of interest rate sensitivity or exposure to the stock market. With active management, convertible securities can be used to support a variety of investment goals and risk tolerances.

CONVERTIBLES: AN OVERVIEW

Convertible securities are less well known than stocks and bonds, but they are a global asset class with a history that traces back to the mid-1800s.

A convertible bond can be exchanged—or converted—into a specific number of shares of common stock of the issuer's company. Convertible bonds are technically classified as debt instruments because they pay interest and have a maturity date.

To learn more about convertibles, [read our guide, "Convertible Securities: Structures, Valuation, Market Environment and Asset Allocation."](#)

Convertibles are an attractive part of an enhanced fixed income allocation, but reduced interest rate sensitivity is not the only potential benefit convertibles offer. Convertibles can also be used to provide lower-volatility participation in the stock market. Because a convertible is linked to its underlying stock through its conversion feature, it tends to rise when its underlying stock does. However, the convertible's bond characteristics—its bond value "floor" and coupon—can help mitigate downside during periods of stock market volatility.

Because convertible securities can be actively managed to adjust to different market and interest rate conditions, they are an attractive choice for the core of an asset allocation. History shows that long-term rates can move suddenly and with little warning, and stocks can also experience unexpected downturns. **An actively managed convertible strategy allows investors to position their portfolios ahead of changes in interest rates and market turns.**

A Historical Perspective on Actively Managed Convertibles

Calamos Investments began investing in convertible securities during the difficult financial markets of the 1970s. Our proprietary investment approach has been tested over multiple market and economic cycles, including a variety of inflationary environments. We found that convertible securities could provide benefits that stocks and bonds could not, and provided a powerful tool for enhancing returns and managing risk for our clients.

We established our first institutional convertible strategy in the late 1970s, and today utilize convertibles in a range of strategies, with tailored risk/reward profiles for client goals (for example, enhanced fixed income or lower volatility). One of our flagship strategies is the Calamos U.S. Convertible Strategy.

The Calamos U.S. Convertible Strategy delivered significant outperformance when long-term interest rates rose. In Figure 1, we show the performance of the strategy during periods where the 10-year Treasury yield has increased more than 1 percentage point. In each period, the Calamos U.S. Convertible Strategy (blue) posted positive performance while traditional fixed income indexes (green and orange) lost value more often than not. Additionally, the strategy often outperformed by a very wide margin.

The Calamos U.S. Convertible Strategy has also outperformed the broad stock market over the 20-year period (Figure 2). The strategy's asymmetrical risk profile has been key to its attractive historical performance. Through active management, the strategy has captured more of the stock market's upside and less of its downside since its inception (Figure 3). By preserving capital on the downside, the strategy can stairstep its way up over a full market cycle.

FIGURE 1: CALAMOS U.S. CONVERTIBLE STRATEGY: OUTPERFORMANCE WHEN RATES RISE

CUMULATIVE RETURNS

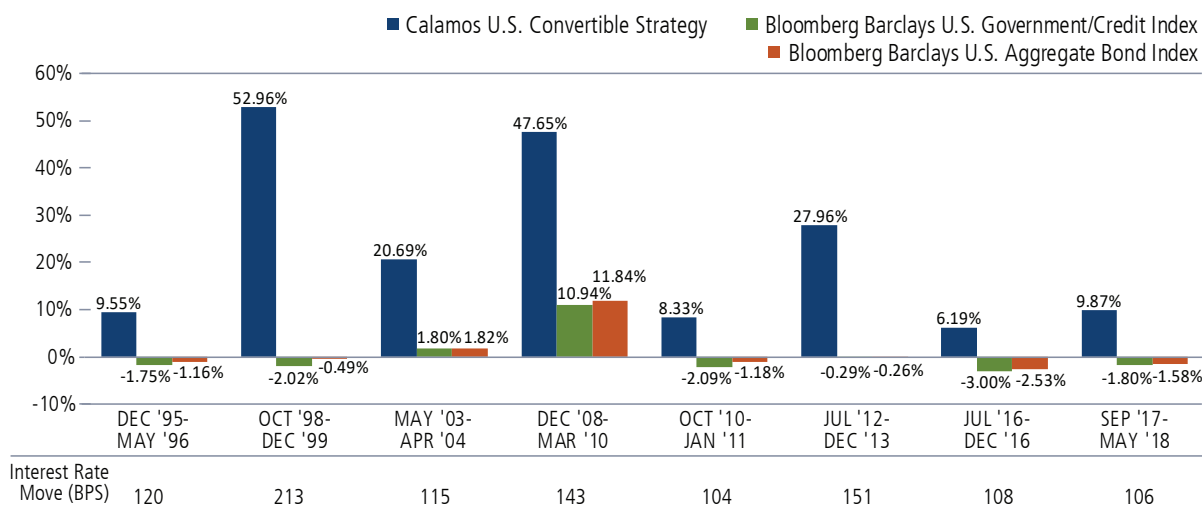


FIGURE 2: CALAMOS U.S. CONVERTIBLE STRATEGY SURPASSED THE STOCK MARKET, WITH LESS VOLATILITY

GROWTH OF \$10 MILLION, 20 YEARS

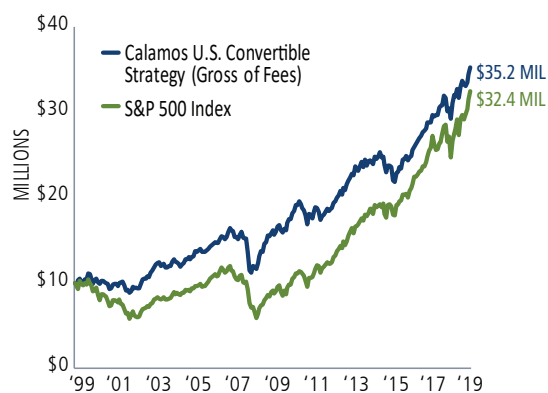
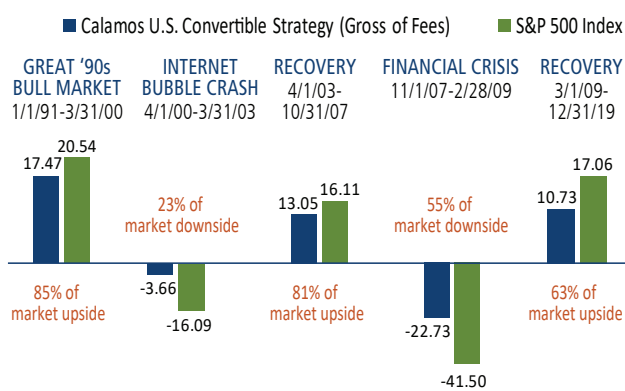


FIGURE 3. A HISTORY OF CAPTURING MORE MARKET UPSIDE THAN DOWNSIDE

ANNUALIZED RETURNS (%) SINCE INCEPTION



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.

Source: Mellon Analytical Solutions, LLC and Federal Reserve Bank of St. Louis. Rising rate environment for full monthly periods from troughs to peak since December 1995. Most recent data as of December 31, 2019. Net of fees, the strategy returned 16.79% during the '90s bull market, -4.20% during the internet bubble crash, 12.38% during the subsequent recovery, -23.18% during the financial crisis, and 9.98% during the recovery. Investors cannot invest directly in an index.

Conclusion

Economic and market conditions can change quickly. Inflation and long-term rates can ramp up suddenly and with little warning, and the stock market can experience sudden downturns in the midst of rapid gains. **Actively managed convertible securities provide a proactive approach for addressing the challenges of inflation, rising rates and market volatility. The Calamos U.S. Convertible Strategy exemplifies the opportunity of actively managed convertible securities over the long term.**

ABOUT THE AUTHOR



John P. Calamos, Sr.
Founder, Chairman and Global Chief Investment Officer

John P. Calamos, Sr. founded Calamos Investments in 1977. With origins as an institutional convertible bond manager, the firm has grown into a global asset management firm with major institutional and individual clients around the world. With 49 years of investment industry experience, John has established research and investment processes centered around a team-based approach designed to deliver superior risk-adjusted performance over full market cycles. He is Chairman of the Calamos Investment Committee, which is charged with providing a top-down framework, maintaining oversight of risk and performance metrics, and evaluating investment processes.

John is often quoted as an authority on risk-managed investment strategies, markets and the economy, and has authored two books on convertible securities. He is a frequent speaker at investment seminars and conferences around the world and appears regularly on leading news networks. He holds a B.A. in Economics and M.B.A. in Finance, both from the Illinois Institute of Technology. After college graduation, he joined the United States Air Force where he served as a combat pilot during the Vietnam War and ultimately earned the rank of Major.

ANNUALIZED TOTAL RETURNS (%), CALAMOS U.S. CONVERTIBLE STRATEGY, AS OF 12/31/19

	1-YEAR	3-YEAR	5-YEAR	10-YEAR	15-YEAR	SINCE INCEPTION (1/91)
Gross of fees	20.46%	12.33%	7.82%	8.13%	7.02%	9.76%
Net of fees	19.63	11.55	7.07	7.39	6.32	9.08

Past performance does not guarantee or indicate future results. Current performance may be lower or higher than the performance quoted. 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. The results portrayed on the preceding pages are for the Calamos Institutional Convertible Strategy. The inception dates and performance results shown are for the 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 Institutional Convertible Composite.

Calamos Institutional Convertible Composite is an actively managed convertible bond composite that invests primarily in high-quality US convertible bonds. The Composite was created March 1, 2014, calculated with an inception date of January 1, 1991. Results include all fully discretionary accounts, including those no longer with the Firm. Fees include the investment advisory fee charge by Calamos Advisors LLC. Returns greater than 12 months are annualized. Chart Data Sources: BNY Mellon Analytical Services LLC and Calamos Advisors LLC.

The **S&P 500 Index** is a market-value weighted index consisting of 500 stocks chosen for market size, liquidity, and industry group representation. It is widely regarded as the standard for measuring U.S. stock-market performance. The **Bloomberg Barclays U.S. Aggregate Bond Index** is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market of SEC registered securities. The **Bloomberg Barclays U.S. Government/Credit Index** comprises long-term government and investment grade corporate debt securities and is generally considered representative of the performance of the broad U.S. bond market. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

Unlike convertible bonds, U.S. Treasury bills are backed by the full faith and credit of the U.S. government and offer a guarantee as to the timely repayment of principal and interest.

The information in this report should not be considered a recommendation to purchase or sell any particular security. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed do not represent the account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings.

Calamos Advisors LLC is a federally registered investment advisor. Form ADV Part 2A, which provides background information about the firm and its business practices, is available upon written request to: Calamos Advisors LLC, 2020 Calamos Court, Naperville, IL 60563-2787 Attn: Compliance Officer.

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