Hedged Equity Performance Drivers

The hedged equity sleeve of the portfolio has been our biggest loser year-to-date, a flip from last year when it was our big winner. This is partly because of the beta of the strategy in an equity market that has declined 20% this year and partly because of how hedge strategies have performed this year. For illustration purposes, the Cboe S&P 500 5% Put Protection Index (PPUT) tracks the value of a hypothetical portfolio of securities designed to protect investors from negative S&P 500 returns by holding a long position indexed to the S&P 500 and buying a monthly 5% out-of-the-money put option as hedge. Year to date, the PPUT Index is down -19.92%, which matches the performance of the S&P 500 Index.

Equity Performance. The S&P 500 Index declined -16.10% during the quarter. The portfolio’s equity sleeve declined with the market and held back the quarterly result.

Volatility. The Cboe Volatility Index (VIX) finished the quarter at 28.71 from its 20.56 value at the beginning and hit a peak of 34.75 on May 9. When viewed in isolation, rising volatility supported the value of option contracts given the higher probability of reaching a strike price. While rising volatility improved premium capture, it was also a headwind to the hedged equity portion of the portfolio given that we are positioned with more short options than long.

Option Skew. Option skew flattened significantly during the quarter. The Credit Suisse Fear Barometer (CSFB) provides a useful statistic for evaluating option skew. Using premium captured by writing 90-day S&P 500 Index call options that are 10% out of the money, the CSFB value is determined by understanding how far out of the money 90-day index puts are purchased to construct a zero-cost collar around the S&P 500 Index. The higher the index

FIGURE 1. CALAMOS MARKET NEUTRAL INCOME STRATEGY RETURNS (%)

<table>
<thead>
<tr>
<th>QTR ENDING 6/30/22</th>
<th>1-YEAR</th>
<th>3-YEAR</th>
<th>5-YEAR</th>
<th>10-YEAR</th>
<th>SINCE INCEPTION (1/91)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Calamos Market Neutral Income Composite</td>
<td>-5.49</td>
<td>-3.95</td>
<td>2.73</td>
<td>3.70</td>
<td>4.32</td>
</tr>
<tr>
<td>Gross of Fees</td>
<td>-5.65</td>
<td>-4.58</td>
<td>2.06</td>
<td>3.01</td>
<td>3.62</td>
</tr>
<tr>
<td>Net of Fees</td>
<td>-5.03</td>
<td>-10.85</td>
<td>-0.77</td>
<td>1.05</td>
<td>1.67</td>
</tr>
<tr>
<td>Bloomberg US Govt./Credit Bond Index</td>
<td>0.12</td>
<td>0.17</td>
<td>0.58</td>
<td>1.06</td>
<td>0.60</td>
</tr>
<tr>
<td>Bloomberg Short Treasury 1-3 Month Index</td>
<td>10.60</td>
<td>11.31</td>
<td>12.96</td>
<td>10.26</td>
<td></td>
</tr>
</tbody>
</table>

Source: Calamos Advisors LLC
Past performance is no guarantee of future results.
Data as of 6/30/22.
value, the more skew is seen in the options market. The CSFB finished the quarter at 16.65, well below where it started at 29.66 and below its long-term average of 21.44. Declining skew has made the use of call and put spreads less lucrative, though we still find it beneficial to utilize these spreads given the elevated volatility.

**Arbitrage Performance Drivers**

The arbitrage strategy includes convertible arbitrage, special purpose acquisition company (SPAC) arbitrage and merger arbitrage.

**Convertible Arbitrage**

With equities and bonds both down double-digits and credit spreads widening, there has been no place to hide. So, it is not surprising to us that the convertible arbitrage sleeve has posted a small decline year-to-date. However, our book has cheapened in the process. Currently, 55% of the convertible arbitrage portfolio is below par (this bucket was much smaller in prior years), and these convertibles have a yield to maturity of 6.6% as of the last week of the quarter.

**Interest Rate Environment**

The yield of the 10-year US Treasury bond began at 2.32% and ended at 2.98%. The Federal Reserve raised its overnight fed funds rate target twice during the quarter up to 1.75% from 0.50%. According to Bloomberg, US high yield credit spreads widened 221 basis points quarter over quarter to 587 basis points over Treasuries. The hike in the fed funds rate improved the carry on the cash received from our short equity positions. (our custodian rebates us the fed funds rate less our roughly 35 basis points of borrowing costs).

**Convertible Valuations.** The theoretical value of a convertible can be determined by the sum of its bond and option components. US Convertibles began the quarter trading at an average 0.84% discount to this theoretical value and ended at a 1.35% discount according to ICE BofA. Cheapening convertible valuations held back the long convertible pricing but created a forward opportunity for pricing arbitrage.

Volatility. As previously discussed, the market saw rising market volatility during the quarter. Unfortunately, the direction of the market was largely down throughout the quarter (number of down days versus up days), and the environment was less supportive to convertible arbitrage because it generally provided less opportunities for trade rebalancing opportunities.

New Convertible Issuance. The market volatility witnessed in the second quarter continued to impede new issuance activity across asset classes. The US convertible market saw $2.8 billion in new issuance while $3.3 billion in new convertibles were issued globally. Global issuance so far in 2022 has reflected the slowest first half of any calendar year. Although we don’t expect a long
lull in issuance, and we saw a trickle of deals in June, it may be a bit longer before the taps reopen.

**Special Purpose Acquisition Company (SPAC) Arbitrage**

The second quarter saw just 16 SPACs price IPOs with a market value of $2.7 billion which brought the year-to-date totals to 70 SPACs issued with a market value of $12 billion. The recent market volatility and concerns about the potential for increased regulations in SPACs continued to hinder IPO activity. There are 171 SPACs that have filed registration statements, which represent another $35.2 billion in potential opportunity should these registered issues IPO in the future. (Source: SPACAnalytics.com).

The trend of slowing SPAC issuance, fewer deal announcements and increased redemptions points to a shrinking SPAC market. That said, we are using SPAC arbitrage opportunistically and still see value in a positive yield to expiration in our SPAC arb portfolio.

New SPAC IPOs continued to include improved terms versus the traditional model that included a $10 bank trust deposit with 24 months to expiration. Q2 IPOs largely came with an overfunded bank trust and a shorter expiration time. The average bank trust deposit with the Q2 IPOs was $10.18 with an average expiration of 14.4 months (Data Source: SPAC Research).

The bulk of the portfolio’s SPACs were purchased at or below the $10 IPO Price, about 99% of the SPAC portfolio holdings are priced below $10.50, and the SPAC holdings are well diversified with 367 SPACs held (slightly reduced from 370 SPACs held on 3/31/22).

**Merger Arbitrage**

We expect merger arbitrage to provide lower volatility and a lower correlation to equity markets with a high potential for positive returns over long time horizons in most market environments. The merger arbitrage holdings add a complementary risk profile to the portfolio, with a beta to S&P 500 somewhere between the convertible arbitrage and hedged equity strategies. The portfolio’s current Merger Arbitrage holdings consist of 26 long equities and convertibles (4 more than 3/31/22).

**Positioning**

We actively manage the allocations based on our view of market conditions and relative opportunities. The portfolio ended the second quarter with a 52% allocation to hedged equity and a 48% allocation in arbitrage, in line with weightings at the start of the quarter. Within the arbitrage allocation, the composition was also largely unchanged. At 37%, convertible arbitrage remained the largest weighting at the end of the quarter (versus 38% at the start), special purpose acquisition company (SPAC) arbitrage closed the quarter at 10% (versus 9% at the start), and merger arbitrage was 2% (versus 1% at the start).

As of the close of the quarter, the portfolio’s hedged equity strategy has a hedge ratio that is on the high side of our targeted range. (The higher the hedge ratio, the less exposure to equity market downside.) The hedge is positioned with a larger put purchase and the addition of put spreads, above and beyond the outright long put allocation we always maintain in the portfolio. However, the call-write position is smaller.

**Outlook**

The market continues to be anxious about a myriad of headlines including high inflation, central bank policy, rising interest rates, the war in Ukraine, supply chain disruption, and upcoming US midterm elections. These have all contributed to bouts of elevated volatility. While a -6.50% (gross of fees) year-to-date result for the Calamos Market Neutral Income Strategy doesn’t feel terribly great, the return is reasonable given that the equity and bond markets have both experienced double-digit declines so far this year. The strategy continues to demonstrate its value in an asset allocation by providing a bond-like return with bond-like standard deviation without completely embracing bond-like risk exposures.

In our last commentary, we noted that equity-related issuance—including in the convertible and SPAC new issue markets—was slow because of market volatility, and this continued to be the case in the second quarter. However, when equity capital markets are closed, convertibles have usually been the first to reopen, and the early deals are often attractively priced. So, although it still may be a bit longer,
it’s likely we will get a deluge of paper once the market begins to open up. The SPAC market is more of an unknown, but since we use SPACs opportunistically, it has less of an impact. And we see other reasons to be excited about the opportunities in convertible arbitrage. In prior drawdowns, convertible securities were not immune from declines, but often enjoyed strong tailwinds when things settled down. Also, the silver lining of a rising fed funds rate is that our return expectations for convertible arbitrage ratchet up with the cost of overnight money.