Professional Pensions

17 May 2012 www.professionalpensions.com

PP Focus: Emerging Markets

A world of choice

Nobody disputes that pension schemes are keen to invest more in the world's buoyant emerging markets. However, question marks remain over how best to invest in these assets.

"Over the past year we have done more searches on emerging markets," says Debbie Clarke, partner and head of the equity boutique at Mercer. "Clients now want to diversify their investments to include them."

Origin Asset Management manages around \$2bn in global equities, of which roughly \$110m is in emerging market equities.
Portfolio manager John Birkhold agrees that interest is growing in this asset class.

"You could see a portfolio wanting 20-25% of its overall equity to be emerging market-related," he says. "There is no question that interest in dedicated emerging markets strategies is increasing across the board from institutions everywhere. We have seen a substantial pick-up in interest."

Birkhold continues: "These markets have much more attractive demographics than developed markets. With young, growing populations, they do not have the indebtedness or the social security entitlement issues facing western governments. In that respect, emerging markets are much more favourable environments for growth."

It is not hard to explain the upturn in enthusiasm for emerging markets. Over the past ten years, the four so-called 'BRIC' countries of Brazil, Russia, China and India have returned 13.9% on an annualised basis, according to MSCI data.

Emerging markets as a whole have returned just over 11% each year for the past decade

Calamos senior vice-president and head of institutional business Martin Coughlan says: "It is a good place to be if you can withstand the likely volatility. The focus on the long term is critical. When investing in emerging markets you have got to be looking at five to ten years out."

In contrast, developed markets have returned just 3% a year for the past ten years, less than a third of what was on offer in emerging markets.

Returns have dipped into the red over recent months for many emerging markets. But looked at over the past 12 months, all the MSCI emerging market indices show positive performances, ranging from +5% for Emerging Markets Latin America, up to more than +22% for Jordan, Egypt and Morocco.

But, while most people are agreed on the desirability of emerging markets, debate

continues over how best to go about investing in them. $\,$

Even without necessarily doing anything, pension funds may find their allocations to emerging markets increasing, as developing regions outgrow more established ones.

"Even by doing nothing you may be passively increasing your exposure to emerging markets," says Origin's Birkhold.

Investing more in global equities could also make sense for those schemes looking for a speedier increase in allocation. Global equities can have up to 13% as a matter of course in emerging equities, says Clarke. "It's not a few percentage points anymore."

A broader perspective

Many schemes should consider allocations from a broader perspective than just the asset class itself, say experts.

"You have to realise there are a lot of stocks in developed markets that benefit from the emerging market consumer," says Birkhold,

There is no question interest in dedicated emerging markets strategies is increasing across the board from institutions everywhere

John Birkhold, Origin Asset Management

pointing to stocks such as Apple, Intel, Microsoft, Mercedes Benz and BMW.

Many companies based in developed markets derive significant amounts of income from emerging markets, without the same degree of risk.

Calamos Investments, which has more than \$1bn (\$620m) invested in emerging market securities and runs dedicated portfolios targeting emerging economies, gains some of its emerging market exposure through developed names.

"In our Emerging Markets Ucits fund we have approximately 50% in emerging market-domiciled companies and 50% in developed market names with significant exposure to emerging economies," says Coughlan.

"When we build our emerging market portfolios we are focusing on revenue exposure and managing risk. This leads us to invest in both emerging market-domiciled companies as well as developed market companies that generate significant amounts of revenue in emerging markets."

In addition, around 20% of the Calamos Emerging Markets Ucits is invested in convertibles. According to Coughlan, convertibles are used, "as a lower volatility equity security, they help us to dampen some of the volatility and manage cyclical risk".

London-based Origin launched a dedicated emerging market strategy in January 2011 that has grown since launch to around \$177m.

"We are seeing a lot of interest from clients and consultants," says Birkhold.

Schemes are taking increased interest in ever more esoteric parts of the emerging market universe, providers report.

"People started with equities, added exposure to sovereign debt and, to some degree, corporate debt," says Coughlan.

"That has expanded to local currency debt. In the longer term evolution of how people view non-developed market exposure, it is logical to expect local currency allocations to increase. More and more people are looking to local currency."

Managers are finding they need to use different techniques for emerging markets.

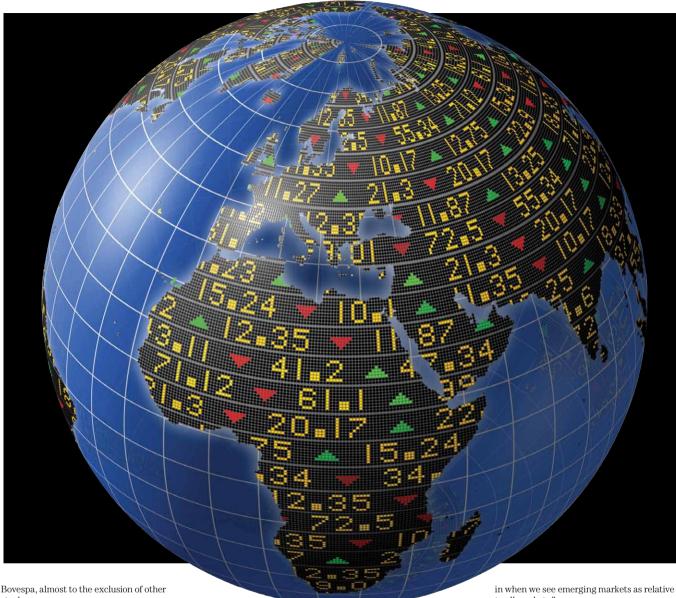
"We focus on looking at the economic freedoms of a country and in particular where we are seeing changes at the margin," says Coughlan. "Historically, we have seen a strong correlation between economic freedoms and increasing GDP per capita."

Among other factors, Calamos looks at an emerging country's level of respect for private property, ease of setting up a business and its fiscal policy. It draws on material compiled by the Heritage Foundation and *The Wall Street Journal* from 184 countries around the world.

"Taking the broad view on how to access growth in emerging economies is the best way," says Coughlan.

Other questions dog the emerging market debate. Not least of these is whether countries considered to be still "developing" really are. Some of them boast higher reserves and lower indebtedness than many countries in the West. However, rapid GDP growth marks out these countries as less mature. Also, says Clarke: "There are still questions around governance that qualify them as emerging."

The immaturity of these markets presents another set of challenges. Many emerging market indices (especially for single countries) are skewed towards one company. Petrobras is notorious for dominating Brazil's



Less is more

Over the past three years, small-cap stocks have tended to outperform large and mid-cap companies. The MSCI EM Small Cap index shows an annual return of 18% over the past three years, compared to 13% for its standard emerging market index over the same period.

It has become possible for schemes to invest in funds dedicated to emerging market small companies. However, at this stage, there are relatively few available and it is a challenging area in terms of coverage and corporate governance.

'Managers are launching more domestic emerging market funds to gain exposure to financials and retail," says Clarke. "These are the areas that benefit as emerging markets are growing, with people wanting bank accounts, health insurance and education. There are some interesting investment

Less convincing is the case for investing in emerging markets via global sector funds, says Clarke. Choosing between sectors could be demanding in terms of pension fund governance, she warns. A better option might be to ask an investment manager to

incorporate strategic sector tilts in their portfolio construction

Regional emerging market funds are available to investors. Origin's Birkhold is unsure these products would suit schemes.

When we build our emerging market portfolios we are focusing on revenue exposure and managing risk

Martin Coughlan, Calamos

"If a pension sponsor has a firm view on asset allocation and the mechanism to execute that view, they should feel free to express it as precisely as possible," he says.

"The difficulty is that many don't have the expertise and therefore it makes sense to allocate to a global manager as they can see the relative attractiveness of markets. We go to all markets.

As emerging markets come of age, there are growing arguments for harnessing rapid economic growth in investable but smaller and less liquid markets via so-called 'frontier' investment.

"We have also seen an increased interest in frontier equity markets," says Coughlan.

Investing in 'frontier' countries such as Bahrain, Bangladesh, Botswana, Sri Lanka, Mauritius, Oman and Vietnam takes pension schemes to the riskier end of the emerging market spectrum.

It can also produce correspondingly higher returns.

Frontier markets overall are up 3% so far this year, while frontier markets in Africa $\,$ (MSCI) are up an impressive 17% over the same time frame.

However, mingled investment vehicles made up of both equity and debt do not always make sense, according to Clarke.

"It is challenging to find managers who are good at both," she says. "Initially it seems quite appealing but our experience has been it is not easy to find."

The same could be said for emerging markets overall - investing in them may sound attractive, but much comes down to turning the idea into practice.

The EM growth story

In this emerging markets panel, the participants discuss the role EM will play in pension fund investment strategies as well as how any risks should be managed

Allocations to emerging markets by pension funds have increased over the last decade - how will this trend develop over the next decade?

JOHN BIRKHOLD: As emerging markets (EM) continue to grow at a faster pace than traditional developed markets (DM), and their capital markets continue to develop, one would naturally assume that the capitalisation of EM stock markets would also outpace those of DM markets and therefore become a larger asset class for institutional investors

However, there are a number of mitigating factors that need to be considered. Firstly several large EM countries namely South Korea and Taiwan, will eventually be 'promoted' to DM status. Second, in many instances the primary beneficiaries of EM growth are often large multi-national DM firms. Therefore, we would not be surprised to see the current EM/DM ratio remain static in equity markets. However, EM fixed interest, currency, private equity and real estate asset classes will undoubtedly become more prevalent in pension fund portfolios over the next ten years.

 $\textbf{MARTIN COUGHLAN:} \ We \ expect \ pension$ funds will continue to gravitate away from 'home country bias' and look globally for alpha, including increased exposure to emerging economies. Macroeconomics and long-term secular trends make the case for progressively larger allocations to emerging markets. While economic growth may slow from the rapid levels over the past years, emerging markets are positioned to drive global growth. The well-documented growing prosperity within emerging markets - particularly the expansion of an emerging market middle class - will be a significant driver of investment opportunity for companies, globally.

Capital goes to where it is treated best, and it can move very quickly to find the economies that offer the greatest opportunities, in both developed and emerging markets. In many of the most important emerging markets, we are seeing increased recognition of the benefits of economic freedom. Of course, this is proceeding at different rates. and is not without challenges, so a careful assessment of risks remains essential.

MAX WOLMAN: Pension funds' emerging markets exposure will evolve. Initially funds sought exposure via equity markets but increasingly there is interest in investing in emerging market bond and property markets. A study by J.P. Morgan shows that US pension funds are heavily underallocated to emerging market debt, with less than 1% allocation, but this trend is expected to change. As the asset class matures and the maturities of the bonds issued by emerging markets lengthen, pension funds will be increasingly allocating fixed income exposure to the EM regions in search of higher yields.

Which asset classes should pension funds invest into in order to gain access to EM economic

JOHN BIRKHOLD: In our view, the best mechanism for capitalising on EM growth is via exposure to global equity growth stocks, where growth is defined as firms that earn and maintain high economic returns while reinvesting organically. By definition, if the developed market world is constrained to low levels of economic growth due to excessive leverage and poor demographics, then companies that are growing their revenue at GDP-plus levels are either taking share from domestic competitors or are benefitting from EM growth. Therefore, a focus on organic profitable revenue growth will provide an investor with the optimal opportunity to profit from EM growth, regardless of where the firm

MARTIN COUGHLAN: We believe that pension funds should assess the opportunities available across the capital markets we see developing in emerging economies. This will include both the US dollar and local currency sovereign and corporate debt markets, as well as equity markets. Equities remain the best way to access growth in emerging markets, according to Calamos research. The Calamos equity valuation model shows that investors are not discounting the potential for future growth. For example, EM, as well as other regions, has median valuations based on free cash flow that are one standard deviation below its longterm averages, which indicates to us betterthan-average return prospects. However, the backdrop of likely higher rates and debt deleveraging may hold off the valuation premium in the foreseeable future

We also believe that as investors look to gain additional exposure to EM, that they consider not only domicile exposure but also economic exposure. In this regard, EM growth can be accessed not only through countries based in emerging markets but also through global companies based in developed markets. This 'companies, not countries' approach is a defining feature of the Calamos approach to EM growth.

MAX WOLMAN: Pension funds should consider a range of asset classes - equities,

John Birkhold, partner, Origin Asset Management LLP





John Birkhold is a partner in Origin Asset Management LLP and a member of the firm's Global Equity Team. Asset Management
He was previously a managing director at Credit Suisse HOLT, where he held a variety of senior roles over a 16-year career including

seven years leading HOLT's Non-US business in London, founding Partner of HOLT's Asia Pacific franchise in Sydney and portfolio

consultant based in Chicago.

Prior to joining HOLT Value Associates, John was an investment analyst for

the Ameritech Pension Fund in Chicago. He started his career as a systems analyst with Titan Systems, a Virginia based defence contractor. John holds a BS and ME in Systems Engineering from the University of Virginia and an MBA in Finance from the University of Chicago.Geraldine is an FPMI and is also a member of PMI Council and a TPAS advisor.

Martin Coughlan, senior vice president, head of institutional



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As part of the portfolio management department, Martin Coughlan's responsibilities include the monitoring of investment portfolio activity, current

positioning and risk attribution.

He represents the portfolio management team, globally, in market and strategy reviews with institutional clients and intermediaries.

In addition, he oversees the sales and distribution efforts of Calamos' institutional business, including direct and consultant relationships. Prior to joining Calamos in 2005, he worked at Bank of Ireland Asset Management, focusing on institutional clients in Europe, Asia and the U.S. markets. Mr. Coughlan is both a CFA and CAIA charterholder and

Max Wolman, portfolio manager, emerging market debt, Aberdeen Asset Management



▲ Aberdeen

Max Wolman joined Aberdeen in 2001 from Liontrust Asset Management initially working as a currency dealer for Aberdeen. In 2002 Max moved to the emerging market debt team as an assistant

portfolio manager to focus on developing the local currency bonds and foreign exchange investments. More recently Max has been specialising in emerging market corporate bonds having helped develop the corporate bond investment process. Max graduated with a BA (Hons) in Business Management and is a CFA Charterholder.

> fixed income, property and commodities when looking to obtain exposure to emerging markets. Investing in EM equities allows an investor to benefit from the domestic growth story and the shift from the investment-led to consumption-led growth that is currently under way. Investing in EM fixed income gives investors access to borrowers with healthier balance sheets, more sustainable debt levels and, in the case of local currency-denominated debt, the potential to benefit from exposure to appreciating EM currencies.

Investing in EM property gives exposure to markets that have not seen the inflated prices, property bubbles and extensive use of leveraged finance observed in the West. A lot of EM countries are commodity exporters so

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investing in commodities, the prices of which have been on the long-term path of appreciation, also gives exposure to the EM growth story.

How risky are emerging markets and how can pension funds manage these risks?

JOHN BIRKHOLD: EM equity investors are clearly exposed to higher levels of risk on multiple dimensions. First, higher levels of economic growth provide more opportunity for boom and bust cycles driven by excessive capital flows, which often lead to firm and country specific issues. Second, corporate governance and respect for shareholder rights are generally not considered 'best practice' in most EM equity markets. Lastly, most EM equity markets tend to be bifurcated, with a small number of large firms and a large

Pension funds can manage the risks of emerging markets by maintaining a preference for countries that are moving in the right direction, in terms of embracing economic freedoms, which can enhance the overall stability of markets and companies within those markets. An emphasis on good cash flows, high return on invested capital, low debt and growth characteristics is essential, especially given the likelihood of more modest global economic growth going forward.

In the current environment, the companies that we see as best positioned to capitalise on EM growth are both local EM companies and larger global companies with geographically diversified revenue exposure. As noted, the manner in which a company is participating in EM growth (source of revenues) is far more important than its location. An opportunistic use of equity sensitive securities, including

JOHN BIRKHOLD: In our view, Indonesia has the best opportunity to emerge as one of the leading EM countries outside of the BRICS. It has a large, young population, an abundance of natural resources and is geographically well placed to capitalise on Asian growth. The primary impediments it faces are in the areas of corruption, excessive nationalism and internal ethnic divisions.

MARTIN COUGHLAN: While the Calamos team closely analyses macroeconomic factors, including those within emerging and frontier markets, the firm's investment process is focused primarily on identifying global investment themes and businesses with diversified revenues and participation in EM growth themes. We are more concerned with finding those businesses wherever they may be headquartered and less focused on



number of smaller, thinly capitalised companies. As ever, a combination of diversification and a focus on accounting quality can help mitigate these risks.

MARTIN COUGHLAN: The risks are real but varied, so active management remains of the utmost importance. As their balance sheets have strengthened, many emerging markets no longer entail the same set of risks that they did 20 years ago, and some would argue many emerging markets represent a lower level of investment risk than many developed markets today.

Still, we expect continued volatility, given the rapid movement of capital flows, the macroeconomic policies of countries themselves, and the events occurring in developed markets, most notably, those related to debt burdens, currency wars and trade protectionism. Emerging markets are still vulnerable, although perhaps to a lesser degree than in the past, to policy missteps elsewhere in the world.

convertible bonds, can also provide access to EM growth with potentially less downside volatility.

MAX WOLMAN: Emerging markets are not without risks, and investors should undertake rigorous due diligence before investing. Emerging markets can boast strong fundamentals and low levels of debt, in the case of both sovereign and corporate borrowers. However, some risks still remain, including political risk and the risk of interest rate increase due to fundamental or technical factors (e.g. policy mistakes). In order to minimise such risks, a portfolio should be well diversified. Pension funds should not focus on investing in dollar-denominated sovereign debt only, but should allocate across the entire universe and therefore consider investing in local currency as well as corporate bonds.

Which emerging markets offer the best prospect of becoming the 'next BRICs'?

particular countries as a means to determine our participation.

MAX WOLMAN: Some investment managers have homed in on the 'BRIC' countries of Brazil, Russia, India and China, based on the theory that these nations are set to become the world's most dominant economies.

While there is no doubting the importance of these populous countries, which are already among the main contributors to global economic growth, BRIC is a 'top-down' idea that can create a distraction – ultimately restricting the investment universe. We prefer to choose our investments from an unconstrained, global emerging market debt universe, using bottom-up analysis.

Although if you were to push us for an answer, Indonesia and also some of Latin America's smaller economies, like Peru and Colombia, are experiencing high levels of growth.

CALAMOS senior vice president MARTIN COUGHLAN discusses investment approaches to access the growth in emerging markets with a minimum of risk exposure

Managing exposure to emerging economies

Before the start of the Great Recession in 2008, market pundits often debated whether a slow down in developed markets would roil the emerging economies. "The developed world sneezes and emerging markets catch a cold" was an often heard phrase. Others postulated that the two markets would decouple and emerging economies would stand strong on their own. Few suggested that the fate $\,$ of the global economy would hinge on the growth within the emerging markets, though many would make that argument today. But growth in emerging economies is not synonymous with, nor limited to, growth by companies domiciled within developing nations. Calamos believes that exposure to emerging markets can be garnered with reduced risk through an investment approach more focused on where a company derives its revenue rather than on where it is domiciled.

The total equity market capitalisation of the developed markets dwarfs emerging economies, much as the rate of emerging economies GDP growth dwarfs that of developed markets. While the emerging markets comprise a small portion of the overall global market cap, their strong, steady growth is reflected in their increasing representation in cap-weighted indices such as the MSCI All Country World Index. Since 2005, the percentage of the index comprised of emerging market companies has more than

doubled, growing from about 5% to 12% of the index, as of March 2012. The continuing growth in emerging markets is impressive. So is their overall contribution to global economic growth. Emerging markets accounted for 49% of global GDP in 2011 according to International Monetary Fund. We believe that such a disparity between emerging economies' current market cap representation and their overall GDP contribution will narrow during the coming years.

Participating in EM growth

How to gain exposure to the growth in emerging economies is a question investors ask and re-ask. The best solution is dependent on each plan's situation and its concerns relative to the added risk that generally accompanies investments in emerging markets. The approach currently favoured by most institutional investors is to focus on emerging markets exposure by investing in emerging market-based companies. These holdings generally come through standalone EM allocations, sometimes segmented into regional and large/small cap mandates, or by allowing global equity managers the flexibility to invest in emerging markets.

These approaches are predicated on the belief that exposure to the growth in emerging economies is best provided through emerging markets companies. We believe this is a false assumption. The economy is global, and cross-border trade builds economic growth for developed and developing countries alike. Emerging markets sell to developed markets, just as developed markets sell into emerging markets.

As an example, for the US equity market, as represented by the S&P 500 Index, on average nearly half of company revenues are from outside their home market. For EAFE companies, on average more than 40% of revenue is from the US and emerging markets, while more than 30% of the average EM company's revenue comes from developed markets.

The investment approach we favour, and that we believe will become more

prevalent in coming years, is
to focus on company revenues by country or
region and on the
growth of these
revenues. In our
view, this perspective more accurately
quantifies exposure
to emerging economies,
provides better insight into
a company's risk and return

potential, and, perhaps most importantly, we believe it offers emerging economic exposure with a lower risk profile.

Region of revenue vs domicile

The analysis of regional revenues is a research focus across our suite of US. non-US, global and emerging strategies. Understanding the revenue exposure at the portfolio level and the individual security level has proven valuable not only to our portfolio construction and risk management processes, but also with client discussions about portfolio positioning. Illustrating region of revenues next to domicile provides a more comprehensive explanation of our analysis and of portfolio holdings. The revenue discussion generally supports our top-down research, which in turn provides context for discussing bottom-up security selection. This information helps investors understand their geographic exposures and risks.

Important at the plan level

Understanding the regional economic exposures is important at the security and portfolio level for managers. For institutional investors. we believe this is equally true for the overall plan, especially within asset classes. One way pension plans can understand their revenue exposure is to break it down among their existing mandates. A pension plan's investment managers should be able to easily provide this information. By aggregating the data across regions, true economic exposure of the overall plan (or asset class) is highlighted, and potential unintended exposures/risks may come to light. Further, such an analysis provides a clearer perspective on how macro developments may affect overall plan returns.

Conclusion

Emerging markets account for half of global GDP, with a growth rate significantly higher than developed economies. How to best access that growth is a question investors continually reassess. We believe an investment approach that focuses on company revenues by region, and on the growth of those revenues, more accurately quantifies regional economic exposure than a focus on country of domicile. Further, we have found this approach to company analysis and portfolio construction can dampen risks at the portfolio level compared to strategies that are constrained to companies domiciled in emerging markets. Whether at the security, portfolio or plan level, we believe a focus on sources of revenue provides investors with a more comprehensive understanding of risks and economic exposures.



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As a result of political or economic instability in foreign countries, there can be special risks associated with investing in foreign securities, including fluctuations in currency exchange rates, increased price volatility and difficulty obtaining information. In addition, emerging markets may present additional risk due to potential for greater economic and political instability in less developed countries.

Heritage Foundation Information Sources: Terry Miller and Kim R. Holmes, 2011 Index of Economic Freedom (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), at www.heritage.org/index.

Emerging markets accounted for 49% of global GDP in 2011 according to the International Monetary Fund World Economic Outlook, September 2011.

Calamos Investments had more than \$1 billion invested in emerging market securities as of 30 April 2012.

The Standard & Poor's 500 Stock Index (S&P 500) is an unmanaged index generally representative of the U.S. Stock Market, without regard to company size. The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index. MSCI EAFE Index is an arithmetic, market value-weighted average of the performance of securities listed on the stock exchanges of selected countries in Europe, the Far East and Australia. The index is calculated on a total return basis, which includes reinvestment of gross dividends before deduction of withholding taxes. The Wilshire 5000 Equity Index is a market-value weighted index which includes all NYSE and AMEX stocks and the most active over-the-counter stocks. The MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The index is calculated in both U.S. dollars and local currencies.

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RBC Dexia Investor Services Ireland Limited I Georges Quay House 143 Townsend Street I Dublin 21 Ireland I Tel: (353) 1 440 6555

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