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As the Taper Begins, What's Next for Asset Allocation?

Over the past months, we have received many questions about the Federal Reserve's (the Fed's) move to taper its quantitative easing (QE) program and the potential impact of tapering on investment portfolios. As we have noted in our recent commentaries, we believe investors should not be discouraged by the taper—the Fed's willingness to reduce its stimulus points to the sustainability of the U.S. economic recovery. We also believe an orderly taper will support more fundamentally driven markets. Finally, we are hopeful that the combination of economic recovery and moderately higher interest rates will incentivize U.S. banks to loan to U.S. small businesses, the engine of job growth and therefore, more sustainable economic recovery.

Of course, the unprecedented scope of QE adds to the challenges of unwinding it. But the Federal Reserve has made it clear that it will maintain a deliberate and flexible course. Still, we expect continued volatility in the financial markets. Long-term interest rates in the U.S. have stayed stable so far, but we believe investors should position their asset allocations to ward against the potential for a more dramatic rise in interest rates.

In this paper, we assess the opportunities in the global markets and the potential implications of macro factors on asset allocation. **We discuss our framework for asset allocation built around the use of core strategies, and our current rationale for underweighting and overweighting asset classes.** Of course, asset allocations should be rebalanced over time in response to changing market conditions.

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I. Outlook

Global economic recovery looks set to continue, albeit at varying paces. In the United States, a healthy consumer, increased merger-and-acquisition activity, good fourth quarter corporate earnings results, growth momentum in the private sector, and positive data in the manufacturing sector all bode well for a sustained recovery. And although the Fed is tapering, overall policy remains accommodative. Short-term interest rates are still almost zero, returns on capital are above the cost of capital, and inflation is well contained.

In regard to the euro zone, we believe that improving macro factors, including expansion in Germany and accommodative European Central Bank (ECB) policy, will likely provide a tailwind for continued recovery over the coming months. We are more cautious about Japan. Although Abenomics got off to a promising start, growth has since slowed and the current account deficit has risen to a record level. Problems such as stagnant wage growth, poor consumer demand, and underutilization of women in the labor force are deeply entrenched.

There's a great deal of uncertainty in the emerging markets (EMs). Better economic fundamentals, a stronger dollar and higher long-term interest rates in the United States have created pressures. These influences, combined with slowing growth prospects and political instability in a number of countries, will likely contribute to broad market volatility as well as country- and company-specific pressures. We expect headwinds for large EM economies such as Russia and Brazil. On the other hand, we believe China is taking many of the right steps to navigate the next phase of its economic development. A variety of smaller EMs (including Mexico and the Philippines) are also positioning themselves for future growth, supported by economic reforms that encourage foreign direct investment.

We must not forget that *monetary policy* is not the only determinant of economic growth. The impact of government *fiscal policy* is also extremely important. As history has demonstrated, economies are more likely to grow when fiscal policy properly incentivizes the investment of capital. Tax policies that encourage capital investment are particularly imperative, given that there are large amounts of capital on the sidelines.

Opinions, estimates, forecasts, and statements of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. The views and strategies described may not be suitable for all investors. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations.

▮ **Monetary policy is not the only determinant of economic growth. The impact of government fiscal policy is also extremely important.**

II. Impact of the Taper on Asset Allocation

Asset allocation is about matching investor risk tolerance to long-term investment objectives. For example, a 40% fixed income/60% equity allocation may be comfortable for one investor, while another investor's situation may call for an allocation with reduced equity risk, along the lines of 60% fixed income and 40% equity.

The challenge for investors is that the risks associated with asset classes can shift. In the current environment, the potential for higher interest rates changes the risk profile of traditional fixed income allocations. Additionally, in an increasingly interconnected global economy, what happens in one country or region influences markets and asset classes worldwide. As a result, we believe successful asset allocation strategies should reflect global perspective, fundamental research and active risk management.

III. The Calamos Approach to Asset Allocation

Our approach to asset allocation goes beyond focusing on traditional asset class categories, and instead considers how a security or asset type can be actively managed to achieve a specific objective over market cycles. At the broadest level, our asset allocation framework includes the following categories: **traditional fixed income, enhanced fixed income, core** and **equity**.

We believe that our use of core strategies is a key differentiator of our asset allocation philosophy. Core strategies are neither tactical overweights nor underweights; rather, they reflect a consistent commitment over full market cycles and an emphasis on preserving capital during down markets. Core strategies may center on long-term durable investing themes, as our experience has shown that a focus on long-term growth trends can mitigate the impact of shorter-term volatility.

Our use of core strategies within the asset allocation framework has its roots in our pioneering use of convertibles, which we have used since the 1970s as a means to potentially manage risk and enhance returns. **Compared with the "balanced" allocations of stocks and bonds upon which other asset allocation approaches rely, our core strategies are structured to provide more upside participation than balanced strategies with similar risk postures.** We seek to provide an asymmetrical risk/return profile, with more equity upside than downside over full market cycles, aiming to outperform the typical balanced strategy.

Asset allocation and diversification do not guarantee investment returns and do not eliminate the risk of loss.

▸ **Our asset allocation framework includes the following categories: traditional fixed income, enhanced fixed income, core and equity.**

Because of our focus on full market cycle performance and downside risk management, we are willing to give up some upside equity market participation for a cushion on the downside. In regard to managing volatility versus the broad market, we may target a beta in the range of 0.70—that is, 30% less volatile than a relevant equity benchmark.

We may place a specific asset type within more than one of the four broad groups (traditional fixed income, enhanced fixed income, core and equity) at different points in the market cycle. As we will discuss, convertibles are a mainstay within the core allocation, but in certain environments we may make further, more-tactical allocations to convertibles within the enhanced fixed income segment. Liquid alternatives may also be used within both core and enhanced fixed income allocations. For example, as we will discuss, given the current rising interest-rate environment in the U.S., we believe it is appropriate to increase convertibles and market neutral income within the enhanced fixed income portion of the asset allocation.

▸ We see considerable risks in outsized allocations to traditional fixed-income securities, both U.S. and global.

Traditional Fixed Income Allocation: Underweight

ASSET CLASS	SEGMENT	OUTLOOK	RATIONALE
Traditional Fixed Income	U.S. Investment Grade	● Underweight	Long-term debt is particularly vulnerable to interest rate risk; conservative duration management is imperative
	Global Bonds	● Underweight	Risk has increased on the back of recent currency volatility (by-product of the taper)

Traditionally, fixed income strategies have been viewed as the less risky portion of an asset allocation, versus more risky equity strategies. With the Federal Reserve’s move to taper, U.S. fixed income strategies are more vulnerable to potentially higher interest rates, while a very low interest-rate environment globally has made it more difficult for traditional fixed income strategies to generate income. Interest rate risk can be managed by maintaining a shorter duration, but unfortunately, a shorter duration means less income. While the specter of rising rates is most immediate in the U.S., we believe the ECB will also dial back its accommodative policy as economic recovery continues. Against this backdrop, we see considerable risks in outsized allocations to traditional fixed income securities, both U.S. and global.

Enhanced Fixed Income Allocation: Overweight

ASSET CLASS	SEGMENT	OUTLOOK	RATIONALE
Convertible	Convertible Securities	● Overweight	Convertibles have demonstrated less sensitivity to rising interest rates, often outperforming traditional bonds in a rising rate environment
Liquid Alternatives	Market Neutral	● Overweight	Market neutral can provide an alternative to interest-rate sensitive fixed-income investments
High Yield	Higher-Quality High Income	● Neutral	Shorter-duration higher-quality high yield has been less sensitive to interest rate risk, compared to investment-grade bonds
Traditional Fixed Income	Global Bonds	● Underweight	Risk has increased on the back of recent currency volatility (by-product of the taper)

Traditional fixed income has lost much of its appeal to us against the backdrop of the taper, but investors who wish to maintain well-diversified portfolios still have many choices, including what we refer to as enhanced fixed income approaches. Although the risk of such strategies has historically been higher than those of investment-grade bonds, there is less potential interest rate risk, while income prospects are better. Convertible bond, higher-quality high income, and market neutral income strategies are examples of enhanced fixed income strategies that we believe can work well in a rising interest-rate environment.

Convertible bonds: Because they have equity characteristics in addition to their fixed income attributes, convertibles have been less susceptible to rising interest rates than investment-grade bonds. Figure 1 shows that convertibles have performed more like stocks than bonds over past periods of rising U.S. interest rates, and at times, have outperformed stocks by a wide margin.

FIGURE 1. CONVERTIBLES: COMPELLING PERFORMANCE IN RISING INTEREST RATE ENVIRONMENTS

AS OF DECEMBER 31, 2013	10/15/93-11/7/94	1/18/96-6/12/96	10/5/98-1/20/00	11/7/01-4/1/02	6/13/03-6/14/04	6/1/05-6/28/06	12/30/08-6/10/09	10/7/10-2/8/11	7/26/12-12/27/13
Yield Increase (bps) [†]	287	154	263	125	176	136	189	115	159
BofA ML All US Convertibles	-2.28%	11.97%	68.85%	2.29%	11.49%	9.46%	24.68%	11.63%	35.49%
S&P 500	2.22	11.42	46.59	3.07	14.66	6.71	9.41	14.89	42.09
Barclays U.S. Govt/Credit	-5.15	-4.08	-3.38	-3.09	-3.64	-1.49	-2.08	-3.94	-2.14

Past performance is no guarantee of future results. Sources: Morningstar and Bloomberg. [†] 10-year Treasury yield. Performance shown is cumulative.

Our use of core strategies within the asset allocation framework has its roots in our pioneering use of convertibles.

Market neutral income: Enhanced fixed income allocations can also include liquid alternative strategies.* For example, in our market neutral income approach, we do not rely on bonds for income. Instead, we utilize a blend of strategies to generate income, primarily covered call writing and convertible arbitrage.

High yield bonds: While we are increasingly wary about investment-grade bonds, we have a relatively more favorable outlook on high yield securities. Still, selectivity will be key as supply/demand trends have led to higher valuations within the asset class as a whole. We are most favorably disposed to mid-grade credits, with an emphasis on conservative duration management. Strategies focused on credits rated B and BB may enhance the income potential of an investment-grade allocation. Or, given the historically lower default rates among mid-tier credits, an allocation to higher-quality high yield may reduce the volatility of a more speculative high yield allocation.

Global bonds: For U.S. investors, non-U.S. bonds may serve a role within the enhanced fixed income allocation. However, reflecting our views about the impact of currency volatility and the potential for other central banks to follow the Federal Reserve’s lead in raising rates, we believe considerable prudence is warranted.

Core Allocation: Maintain Throughout Market Cycles

ASSET CLASS	SEGMENT	OUTLOOK	RATIONALE
Convertible	Convertible Securities	● Neutral	Convertibles may provide lower-volatility participation in the equity market over full market cycles; this lower-volatility approach may be achieved through dedicated convertible strategies or those that blend equities and convertibles
Equity	Emerging Markets	● Neutral	Core allocations often focus on providing exposure to durable global growth themes, such as the rise of the EM consumer. When used as a core allocation, EM exposure emphasizes risk management and seeks an asymmetrical risk profile with more equity upside than downside over full market cycles
Liquid Alternatives	Long/Short Strategies	● Neutral	May provide diversification, and downside protection during declining markets versus long-only strategies

* A number of strategies once almost exclusively available to hedge fund investors can now be found in mutual fund structures that provide greater liquidity, transparency and more reasonable investment minimum hurdles. Because of these features, such funds may be referred to as “liquid alternatives.” Alternative strategies may not be suitable for all investors. In addition to the usual market and investment risks associated with mutual funds, alternative funds have other risks based on the strategies they utilize.

As discussed, while **core allocations span a variety of security types and approaches, they share a common focus on capturing upside equity market potential with downside risk management over full market cycles.**

Convertible securities: In addition to using convertibles tactically within the enhanced fixed income category when conditions dictate, we use them as a cornerstone within core strategies. To pursue lower-volatility equity exposure, we may utilize them within dedicated convertible strategies or within strategies that include equities as well. As hybrid securities, convertibles provide equity upside participation with potential downside protection when equity markets decline. This may offer a more comfortable way to access the equity markets for investors who are especially concerned about volatility.

Long/short equity: Liquid alternative strategies can be incorporated into a core allocation. For example, a dedicated long/short strategy can further the diversification of an overall equity allocation, because the short positions may provide upside when equities are retreating. (Short positions are established by borrowing an equity, selling it and buying it back.) Long/short strategies historically have provided equity-like returns with lower volatility than the U.S. equity market.

Global secular growth opportunities: We also believe that core strategies should provide investors with a way to participate in long-term growth themes, even if those themes are tied to more risky markets. For example, we utilize convertibles and other techniques to provide risk-managed access to the secular growth opportunities associated with the volatile emerging markets.

▸ **In addition to using convertibles tactically within the enhanced fixed income category when conditions dictate, we use them as a cornerstone within core strategies.**

CONVERTIBLES AND ASSET ALLOCATION

Convertible securities can enhance a wide range of asset allocations by providing both core lower-volatility equity and enhanced fixed-income exposure. For more on the use of convertibles in asset allocations, please see our white paper, [“The Case for Strategic Convertible Allocations.”](#)

Equity Allocation: Overweight U.S. Growth

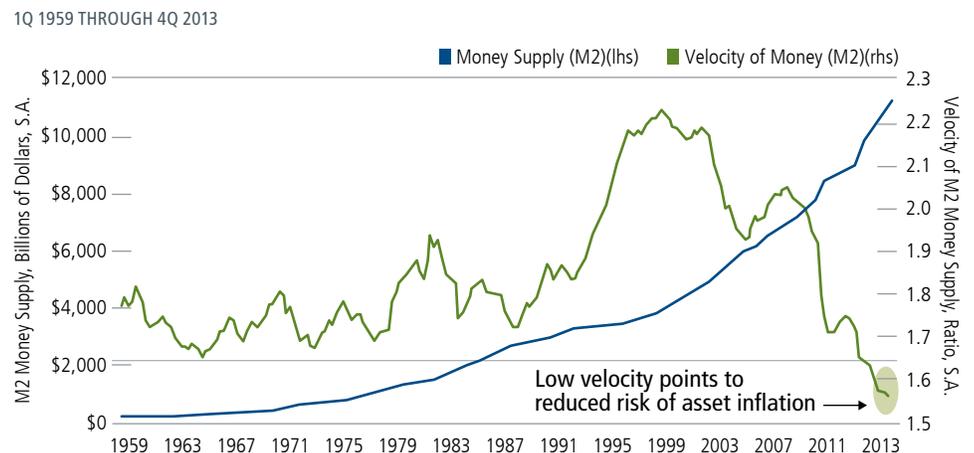
ASSET CLASS	SEGMENT	OUTLOOK	RATIONALE
Equity	U.S. Growth	● Overweight	Valuations are attractive, with little evidence of a bubble
	U.S. Value	● Neutral	Appreciation in 2013 may have inflated valuations
	International Developed	● Neutral	Economic landscape is improving in euro zone, Japan, while valuations provide a cheaper alternative to EMs
	Emerging Markets	● Neutral	Secular growth themes are intact and compelling, but near-term volatility and slower growth are likely to persist

▀ We believe the case for overweighting U.S. growth equities is strong.

Because the risk/reward potential in the global equity markets is continually changing, geographic considerations must be actively managed within an asset allocation. Determining which areas of the global markets to overweight or underweight is a highly consequential decision.

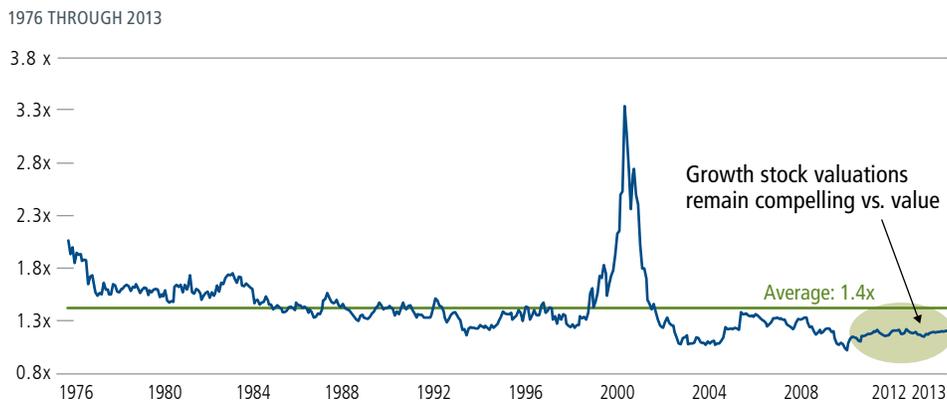
U.S. growth equities: We believe the case for overweighting U.S. growth equities is strong. As QE progresses, long-term rates will likely rise, but moderately higher longer-term interest rates (in the 4% to 5% range) have been associated with higher P/Es among U.S. stocks. Of course, a steep run-up in rates and a sharp spike in inflation could create headwinds in equities, but core inflation is well contained at less than 2%, and the historically low velocity of money points to a reduced likelihood of asset inflation (Figure 2).

FIGURE 2. VELOCITY OF MONEY IS AT HISTORIC LOWS



Source: Federal Reserve Bank of St. Louis

FIGURE 3. U.S. LARGE CAP GROWTH RELATIVE TO NON-GROWTH, RATIO OF FORWARD-P/E RATIOS



Past performance is no guarantee of future results.

Source: Corporate Reports, Empirical Research Partners Analysis. Capitalization-weighted data.

Overall, we believe the **U.S. equity market looks to be in the mid-phase of a secular bull market, with particularly attractive valuations among growth equities**, where there's little premium for growth over value (Figure 3). However, correlations among stocks are moving downward, pointing to rekindled investor focus on fundamentals, which we believe will favor active growth equity strategies. More specifically, cyclical growth names—in sectors such as information technology, consumer discretionary and industrials—have typically fared well when interest rates have risen during a period of economic recovery.

Developed market equities: In regard to developed markets outside the U.S., our outlook is neutral. With the worst of its economic troubles behind it, we believe the euro zone offers bottom-up opportunities and attractive pockets of valuations. Still, given our macro outlook, most clients should cautiously allocate to the region. Similarly, we recommend prudence in regard to Japan allocations. Valuations in 2013 soared as investors anticipated a best-case outcome for Abenomics, but equities may have outpaced growth potential in light of structural hurdles.

Emerging market equities: As we noted earlier, we believe that EM secular growth themes warrant a place within core allocations. We see opportunities for more tactical EM exposure as well, but believe that the current uncertainties discussed earlier in our outlook underscore the need for a selective approach. As in the U.S. market, EM correlations are on the decline, with some countries and industries positioned for much better prospects than others.

Against this backdrop, investors must decide which emerging markets look most attractive. Investors will be best served by including highly active and selective EM strategies within their equity allocations, rather than more benchmark-constrained approaches. Strategies that track the broad EM stock market will be more vulnerable to the more troubled countries (such as Russia and Brazil), and less exposed to the more compelling growth opportunities (such as in technology).

IV. Conclusion

The investment landscape is always evolving. The tapering of QE will likely result in new risks, but also new opportunities, particularly for active investment strategies. **Taking a long-term perspective is the key to capitalizing on the upside while mitigating the potential downside.** While investors shouldn't let short-term ups and downs dictate a string of changes to their asset allocations, the taper should prompt a portfolio check-in with an advisor, who can assess a portfolio's vulnerability to rising interest rates. Traditional strategies—such as those built around investment-grade bonds—may have lost their luster, but there are many different choices for building a well-diversified asset allocation.

V. Summary: Asset Class Outlook in a Rising Rate Environment

	ASSET CLASS	SEGMENT	OUTLOOK	RATIONALE	
EQUITY	Equity	U.S. Growth	● Overweight	Valuations are attractive, with little evidence of a bubble	
		U.S. Value	● Neutral	Appreciation in 2013 may have inflated valuations	
		International Developed	● Neutral	Economic landscape is improving in euro zone, Japan, while valuations provide a cheaper alternative to EMs	
		Emerging Markets	● Neutral	Secular growth themes are intact and compelling, but near-term volatility and slower growth are likely to persist	
CORE	Convertible	Convertible Securities	● Neutral	Convertibles may provide lower-volatility participation in the equity market over full market cycles; this lower-volatility approach may be achieved through dedicated convertible strategies or those that blend equities and convertibles	
		Equity	Emerging Markets	● Neutral	Core allocations often focus on providing exposure to durable global growth themes, such as the rise of the EM consumer. When used as a core allocation, EM exposure emphasizes risk management and seeks an asymmetrical risk profile with more equity upside than downside over full market cycles
		Liquid Alternatives	Long/Short Strategies	● Neutral	May provide diversification, and downside protection during declining markets versus long-only strategies
ENHANCED FIXED INCOME	Convertible	Convertible Securities	● Overweight	Convertibles have demonstrated less sensitivity to rising interest rates, often outperforming traditional bonds in a rising rate environment	
		Liquid Alternatives	Market Neutral	● Overweight	Market neutral can provide an alternative to interest-rate sensitive fixed-income investments
		High Yield	Higher-Quality High Income	● Neutral	Shorter-duration higher-quality high yield has been less sensitive to interest rate risk, compared to investment-grade bonds
		Traditional Fixed Income	Global Bonds	● Underweight	Risk has increased on the back of recent currency volatility (by-product of the taper)
FIXED INCOME	Traditional Fixed Income	U.S. Investment Grade	● Underweight	Long-term debt is particularly vulnerable to interest rate risk; conservative duration management is imperative	
		Global Bonds	● Underweight	Risk has increased on the back of recent currency volatility (by-product of the taper)	

ABOUT THE AUTHOR

John P. Calamos, Sr. is chairman, chief executive officer and global co-chief investment officer of the firm he founded in 1977, which he took public as Calamos Asset Management in 2004 (Nasdaq: CLMS). A recognized authority on convertible securities, he has pioneered investment strategies and techniques to help manage risk for major institutional and individual investors for more than 40 years.

He has shared his expertise in two books, *Convertible Securities: The Latest Instruments, Portfolio Strategies, and Valuation Analysis* (McGraw-Hill, 1998) and *Investing in Convertible Securities: Your Complete Guide to the Risks and Rewards* (Longman Financial Services Publishing, 1988). He has also authored numerous articles in various financial journals and is a frequent guest on nationally syndicated financial networks, including CNBC, Bloomberg TV and Fox Business Channel.

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Investments in overseas markets pose special risks, including currency fluctuation and political risks, and greater volatility than typically associated with U.S. investments. These risks are generally intensified for investments in emerging markets.

The price of equity securities may rise or fall because of changes in the broad market or changes in a company's financial condition, sometimes rapidly or unpredictably. These price movements may result from factors affecting individual companies, sectors or industries.

Fixed income securities are subject to interest rate risk and default risk. If rates increase, the value of fixed income investments generally declines. The risk of default is increased among high-yield securities. Convertible securities are subject to interest rate risk and credit risk.

A credit rating is a relative and subjective measure of a bond issuer's credit risk, including the possibility of default. Credit ratings are assigned to companies by third-party groups, such as Standard and Poor's. Ratings are measured using a scale that typically ranges from AAA (highest) to D (lowest). Assets with the highest ratings are referred to as "investment grade" while those in the lower tiers are referred to as "noninvestment grade" or "high-yield."

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Short sales entail potential for unlimited losses and leverage risk.

As the writer of a covered call option on a security, the investor foregoes, during the option's life, the opportunity to profit from increases in the market value of the security, covering the call option above the sum of the premium and the exercise price of the call.

The S&P 500 Index is considered generally representative of the market for U.S. stocks; the BofA ML All U.S. Convertible Index is considered generally representative of the U.S. convertible market; the Barclays Government/Credit Index is a measure of the U.S. government and corporate bond market. Indexes are unmanaged, do not include fees or expenses and are not available for direct investment.

Abenomics refers to the economic policy introduced by Japanese Prime Minister, Shinzo Abe. Abenomics is made up of quantitative easing, stimulus and inflation targets. **Beta** is a historic measure of an investment's volatility, which is one measure of risk. A beta of 0.5 reflects 1/2 of the market's volatility versus a benchmark, while a beta of 2.0 reflects twice the volatility. **M2** is a measure of money supply that includes cash and checking deposits (M1) as well as near money. "Near money" in M2 includes savings deposits, money market mutual funds and other time deposits, which are less liquid and not as suitable as exchange mediums but can be quickly converted into cash or checking deposits. **Quantitative Easing (QE)** is a government monetary policy the U.S. Federal Reserve has used to increase the money supply by buying government securities or other securities from the market, with the intention of promoting increased lending or liquidity. **Tapering** in financial terms is used to refer to the anticipated reduction of the Federal Reserve's quantitative easing, or bond buying program. **Velocity of money** is the rate at which money is exchanged from one transaction to another, and how much a unit of currency is used in a given period of time.

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INVESTMENTS

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