

## Perspectives on Fixed Income: “Thinking Outside the Box” to Achieve Long-Term Results

Matt Freund, CFA, joined Calamos in late 2016 to serve as Co-Chief Investment Officer and Head of Fixed Income Strategies. He also serves as a Senior Co-Portfolio manager, leading our dedicated fixed income team. Here, he discusses the benefits of thinking outside the box, what sets the Calamos approach apart, and his view of the fixed income markets today.

### Q. What drew you to Calamos Investments in 2016?

**A.** I've been managing portfolios for nearly 30 years and during that time, I've really come to believe that you need a differentiated perspective to outperform. It's all about thinking outside of the box. I was attracted to Calamos because of its willingness to diverge from the herd and to see opportunities that the pack may miss.

I'm a big believer in risk management, too, which ties nicely to Calamos' history. Since John P. Calamos, Sr. founded the firm more than 40 years ago, Calamos Investments has a history of launching strategies that are both innovative and risk managed, including a number of strategies where bonds play an important role.

John is globally recognized for his pioneering use of convertible bonds to enhance returns and manage risk. So, our experience in credit research dates back to the very founding of the firm. Calamos continued this pioneering approach by launching one of first liquid alternative U.S. mutual funds in the 1990s—an income-oriented market neutral strategy. Then, in 2002, the firm branched out into closed end funds, with its first of six product launches. These funds invest dynamically across asset classes, including in high yield bonds, and convertible bonds.

Being a part of Calamos' legacy in fixed income had a lot of appeal for me, but I'm even more excited about what the future holds. We've undertaken a significant build-out of our fixed income team since I arrived. We've brought aboard senior level analysts as well as another portfolio manager. These recent hires average more than 20 years of experience, and it's great to be working with such a strong group. This depth of experience positions us really well for the environment we expect. There's still plenty of opportunity in fixed income—but now it's less about the

sector you're in and more about the individual opportunities. Experience will matter more from here.

### Q. What do you believe are the most important differentiators in your fixed income approach?

**A.** We take a bond-by-bond approach driven by fundamental research. We focus on being well compensated for the risks we take and on keeping trading costs low. If we identify securities that can provide higher yields and we can keep costs lower, the end result is more income for investors. Also, we can diversify idiosyncratic risk, which in my experience makes a big difference in keeping portfolio volatility lower than our peers over time. While we are mindful of macro considerations, we spend the majority of our time focused on individual issues. This is an approach that I've used for decades—through credit, economic, market and interest rate cycles.

One of the benefits of our approach is that it can either serve as the cornerstone of a fixed income allocation, or it can complement existing allocations to either macro or “closet index” fixed income strategies. The closet indexers make lots of small bets. With these strategies, an investor is getting the volatility of the benchmark and probably too much diversification. There's not a lot of opportunity to add value through security selection.

Whereas the closet indexers may be overly diversified, the macro managers may struggle to achieve sufficient diversification because there aren't that many macro levers to push for fixed income. You're primarily looking at duration, currency, sectors (for example, mortgage bonds versus credit), and yield curve.

**Q. How would you describe your philosophy toward trading?**

**A.** We are high-conviction, buy-and-hold investors. Keeping unnecessary transaction costs down is good for clients. It's important to remember that it's not what you earn that matters, it's what you keep. Our bond-by-bond approach gives us an edge in keeping turnover and transaction costs low. Macro managers often invest with a catalyst in mind, and hope there will be liquidity when they want to move on. That can be hard to do if you are on the same side of the market. And even if the trade is there, transaction costs add up particularly fast. Unlike the macro managers, we're not in the business of chasing catalysts.

**Q. What's your approach to managing duration?**

**A.** Successful timing of duration bets is nearly impossible over the longer term. The general consensus has been that interest rates are going up. But many managers have been positioned for this for nearly a decade and have underperformed as a result.

We avoid extreme duration bets. Instead, we favor moderate duration stances. Generally and from a philosophical standpoint, I favor fairly tight bands on portfolio duration, within a year of the benchmark and more often than not, within a half year. Duration is one of those macro levers I mentioned earlier, and more extreme "all-in" duration positioning can result in increased trading costs and liquidity requirements.

**Q. Can you give an example of how you "think outside the box"?**

**A.** I believe that a broader investable universe enhances portfolio construction and risk management. Our investment process is benchmark aware, not benchmark constrained. When our proprietary credit research leads us to what we consider to be a "best idea," we're more than willing to establish a meaningful overweight. Conversely, we'll hold meaningful underweights (or often nothing at all) in names where credit risks are not rewarded.

Depending on the parameters of a particular strategy, we will invest opportunistically outside the benchmark, including in asset classes beyond traditional fixed income. We will opportunistically use convertible securities, exchange traded funds, preferred stocks and equities to enhance risk/return characteristics and support liquidity management.

**Q. Bond skeptics are leaning on expectations of rising rates and improving economic conditions. What's your view of the fixed income markets from here?**

**A.** Coming out of September's Federal Open Market Committee meeting, the Fed noted that it may raise short term rates four times by the end of 2018. I believe we may well see a slower and more gradual course of tightening. We're already close to the Fed's targeted real neutral fed funds rate, and inflation still remains contained. While a number of measures of economic growth have trended positively over recent quarters, the economy isn't showing signs of overheating.

The Fed also announced its intentions to begin its balance sheet normalization in October, with guidance that aligned with our expectations. From here, it's important to keep in mind that the Fed's guidance is a ceiling, not a floor. How balance sheet normalization plays out from here will be subject to market conditions, geopolitical conditions and any Fed leadership changes. At the same time, other global central banks—especially the BoJ or ECB—could have a considerable impact, either augmenting or offsetting the Fed's actions.

There's little reason to believe the Fed's plans for "gradual and predictable" normalization will roil the market. The Fed is working through a tremendous excess reserve. It's not unlike being in the deep part of a swimming pool. If you can't touch the bottom, it doesn't matter if you're in water that's 10 feet deep or 20 feet deep. You just have to swim toward the shallow end. At some point, the liquidity will drain, and we may see more of an impact. But I don't believe that's right around the corner.

Since the Fed has begun tightening, the long end of the curve has remained well behaved, and our team expects this to continue. This has come as a surprise to some investors, but it really shouldn't be. Many people believe that short and long term rates rise in tandem, but parallel shifts in the yield curve have been quite rare. I don't expect yields to bottom out in the U.S. until the next recession, which is unlikely to be imminent.

Meanwhile, global central banks may have signaled an intention to be less accommodative, but we haven't yet seen any significant policy changes. Against this backdrop, yields in the U.S. are likely to remain more attractive than in other high quality and liquid developed economies, such as Japan, where 10-year rates are still negative, or many European economies.

**Q. What is your team’s outlook for higher-yielding credits?**

**A.** Overall, we believe the prices of many high yield securities currently reflect an optimistic outlook and little room for error in company operations. However, this is an environment where I believe our bond-by-bond approach can be particularly valuable. We don’t need to be in an environment where a “rising tide is lifting all boats.” There are still opportunities to be had in the out-of-favor industries—currently retail, specialty pharmaceuticals, and telecommunications, to name a few. You just need to know where to look.

More broadly, this approach flows through to how we opportunistically incorporate high yield in our investment grade portfolios. Depending on the market environment, our team can find select high yield issues that can enhance the overall risk/return characteristics of the strategy. We’re still keenly attune to fundamental considerations—such as consistent free cash flow, capital structure, and company performance versus industry peers.

**Q. Matt, do you have any closing thoughts for investors?**

**A.** For most of my career, investors bought equities for capital appreciation and bonds for income. Since 2008, that’s been reversed. I believe we are at the beginning of a long transition as both asset classes return to their traditional roles.

Investors need to remember that there are main three reasons to own fixed income: The asset needs to be cheap, provide needed income or serve as a hedge against other positions in a portfolio. While there are sectors that are cheap today, the market has already discounted a lot of good news. So today, cheapness isn’t the primary reason, from an asset class standpoint. Even so, the income an actively managed fixed income portfolio can provide remains compelling given the alternatives, and we expect fixed income to continue to serve as a good hedge against unforeseen market events and turbulence.



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R. Matthew “Matt” Freund is a highly accomplished portfolio manager and team leader with nearly 30 years of recognized success in investment management and research. He brings extensive experience in asset allocation, manager selection, and fixed income portfolio management, including a long-term track record of consistently exceeding investment grade and high yield peer groups.

Matt joined Calamos in November 2016 from USAA Investment Management Company, where he had served as Chief Investment Officer—USAA Investments since 2010. In this role, he managed more than 75 investment professionals across a variety of asset classes, with total assets of more than \$140 billion. Under his leadership, USAA was awarded Lipper’s Best Fixed Income Large Fund Group in 2014 and 2004. Additionally, he managed a variety of fixed income portfolios and served as Director of Fixed Income Research from 1994 through 1999. In this capacity, he hired and managed a team of 20 research professionals. Prior to joining USAA, Matt worked for Metropolitan Life Insurance Company—Capital Markets Group as a Senior Investment Analyst, with responsibilities that included performing onsite in-depth analysis of MetLife’s international investment operations.

He is frequently sought for his insights, including by the Wall Street Journal, CNBC, Bloomberg TV and Radio, Forbes, Reuters, and the Milken Institute. Matt holds an MBA from Indiana University, where he was a finance major with an investment concentration. He earned a B.A. from Franklin and Marshall College with a major in accounting.

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Fixed income and convertible securities risk: The value of a security is influenced by changes in interest rates, with investment value declining as interest rates increase and increasing as interest rates decline. The credit standing of the issuer and other factors also may have an effect on the security's investment value.

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