FROM THE DESK OF FOUNDER'S CORNER JOHN P. CALAMOS, SR.

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Convertible Securities: A Compelling Choice for Uncertain Times

Since March's panicked selloff, we've seen a number of encouraging signs on the investment horizon, and there's cause for cautious optimism. Global monetary and fiscal stimulus has been sweeping in scope and there's liquidity in the markets. Stocks have rallied and spreads have tightened off their lows. Many businesses have devised innovative solutions to adapt in this unprecedented period, and companies are accessing the capital markets to shore up their balance sheets. In much of the U.S. and around the world, economic activity is restarting.

With active management, convertible securities can provide unique opportunities through even the most complex environments.

Unfortunately, no one has a crystal ball. Investors who wait for the "all-clear" signal may find they have missed the opportunity. Also, we are still in the midst of heightened uncertainty—and this is unlikely to change over the near term, especially as U.S. elections approach with implications for fiscal policy. Getting back to more normal levels of activity may feel like we are taking "two steps forward, one step back." Even with stimulus and support, not all businesses will survive. As the economy recovers, we are likely to see leadership rotation in the markets.

For investors who are afraid to be in the market but also recognize the value of staying invested, convertible securities may be especially beneficial. Convertible security strategies can be a compelling choice for an asset allocation core because they lessen the need to make a timing call about the stock market, interest rates or economic recovery.

Because convertibles combine attributes of stocks and traditional fixed income securities, they can provide many potential benefits. Below, I've summarized some attractive features of the asset class.

Reasons for Convertibles:

1. **Historically lower volatility equity participation.** Convertibles can benefit as their underlying equities appreciate because the convertible's embedded option (to convert to common stock) becomes more valuable. However, the fixed income attributes of the convertible—such as coupon income and the bond floor—may provide a potential cushion when stock markets are volatile. We believe this will be an extremely important benefit in the coming months given the potential for markets to move upward, but with considerable volatility along the way.

2. **Access to higher growth names.** The convertible universe is dominated by growth-oriented companies, including small and mid-caps. Because their fixed income characteristics may mitigate equity volatility, convertibles can provide a way to access this growth, with potentially less exposure to equity risk.

3. **Positioned for a variety of economic recovery scenarios.** As I noted, it's impossible to predict the exact trajectory of the economic recovery. However, the structural features of convertibles may provide an edge in any number of scenarios:
   - If we have a generally straight up V-shaped recovery, we'd expect stocks to rally, too. As equity-linked securities, convertibles are also positioned advantageously.
   - If we are in an "L" shaped period with a more delayed recovery, the fixed income characteristics of the convertible can provide resilience.
   - If we have a "W" shaped recovery characterized by saw toothed conditions, convertibles can benefit from both their equity and fixed income characteristics. With active management, we can seek to "stair step" through the volatility—endeavoring to capture more of the upside than the downside as markets gain and retreat.

4. **Attractive valuations.** Relative to longer-term levels, convertible valuations are very compelling on the whole, with many issues trading at an unusually wide discount to fair value. However, I'd note that the Calamos Investment team has invested through many valuation environments, including periods when the overall market is trading at less steep discounts or even premiums. **It's important to remember that successfully utilizing convertibles is very much about bottom-up investing—not simply buying the market as a whole.**

5. **A risk-aware way to build global equity exposure.** As of the end of April, the global convertible market is valued at $319 billion, with non-U.S. issuers representing $108 billion—or one-third of the overall market. At this size and scale, convertibles can provide access to a breadth of global growth prospects, with potentially less exposure to equity market downside.

6. **Historically attractive default profile.** Convertible securities have historically had lower defaults than high yield debt.* Overall, issuers of convertible securities have tended to be less levered than issuers of high yield bonds. Balance sheet quality will be a crucial consideration in this next phase of the economic cycle.

7. **A growing universe of opportunity.** Convertible issuance has been healthy over recent years, as companies have sought access to capital in a growing economy. 2018 and 2019 both saw about $85 billion in new issuance globally. This year, however, is shaping up to be even more robust. Global companies have brought $54 billion to market through mid-May, including a surge of about $33 billion since the end of the first quarter. In April, U.S companies issued $13.5 billion—the most seen in a single month since 2008. Moreover, these issues have been coming to market with very attractive structures. We've also seen a wide array of issuers, which provides our active approaches with additional opportunities to diversify and enhance the risk/reward characteristics of our portfolios.

8. **Income less vulnerable to interest rates.** In addition to providing strategic benefits as a historically lower-volatility equity strategy, convertibles can be used within an enhanced fixed income allocation. Like traditional fixed income investments, convertible bonds offer coupon income. However, because of their equity characteristics, convertibles have tended to be less vulnerable to changing interest rates than traditional bonds. 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.

9. **A potential inflation hedge.** Inflation is currently not a problem, but as the economy gets up and going, pent-up demand and episodic supply chain dislocations could fuel inflation pressures. Additionally, a move to more regional supply chains may result in higher costs for goods manufactured in the U.S. Inflation typically takes a greater toll on traditional bonds than equities. So, convertibles may allow investors to position ahead of a potential rise in inflation.

*Source: Barclays, data from 2003 to December 2019, U.S. market. High yield default rate averaged 3.4% versus 1.9% for convertibles.

Conclusion

Convertible securities can offer many benefits to investors but active management is essential. The complexity of the convertible security is what makes it so versatile, but if these attributes are not managed correctly, a convertible portfolio can become exposed to unintended risks. (For a deeper look on how convertibles work, see our guide, one of many items in our online convertible resource center.) With active management, convertible securities can provide unique opportunities through even the most complex environments.

Our experience with convertibles dates to the 1970s. Throughout the decades, we have expanded our convertible capabilities and utilize convertible securities to address a breadth of asset allocation needs. Depending on the specific needs of our clients, we may include dedicated convertible portfolios or strategies that blends of stocks and convertibles, with a focus on either U.S. or global opportunities. For clients who wish to enhance their fixed income allocations with alternative strategies, our market neutral income approach utilizes convertible arbitrage as a core strategy for seeking income and stable performance.

Source for market size an issuance amounts: Bank of America Securities.

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Asset allocation and diversification do not guarantee a profit or protect against a loss.

Important Risk Information.

The value of a convertible 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 convertible security's investment value. Convertible securities and corporate bonds entail interest rate risk and default risk.

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.

Alternative strategies entail added risks and may not be suitable for all investors. In addition to the risks listed above, principal risks of the market neutral income strategy include: equity securities risk consisting of market prices declining in general, convertible securities risk consisting of the potential for a decline in value during periods of rising interest rates and the risk of the borrower to miss payments, synthetic convertible instruments risk, convertible hedging risk, covered call writing risk, options risk, short sale risk, interest rate risk, credit risk, high yield risk, liquidity risk, portfolio selection risk, and portfolio turnover risk

An investment in a Calamos strategy is subject to risks, and you could lose money on your investment in the strategy. There can be no assurance that a strategy will achieve its investment objective. Your investment in the Strategy is not a deposit in a bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation (FDIC) or any other government agency.

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