CALAMOS INVESTMENTS

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Convertible Securities: Market Review and Outlook

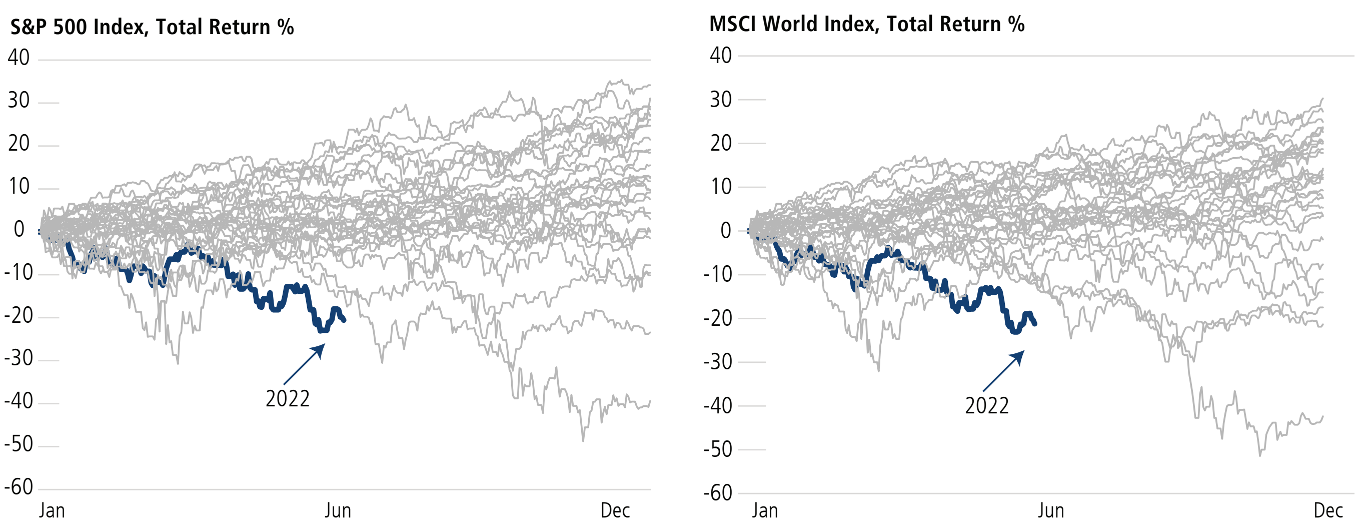
Long term, convertible securities have provided a favorable risk/reward dynamic. With active management, convertibles can provide a powerful complement to other pieces of an asset allocation. Most typically, convertible securities have historically acted like stocks when equity markets are rising but have displayed the benefits of bonds when the equity market isn't garnering as much favor.

Over recent months economic and market conditions have created an unusual backdrop for all risk assets, convertibles included. To help address investors' questions about why the convertible market has behaved the way it has this year, we'd like to share our midyear assessment.

The stock market is going through one of its worst starts on record.

Figure 1 tracks 30 years of returns for the S&P 500 and MSCI World Index. Each line represents the path of the stated index over a calendar year. We've highlighted 2022—the worst start to the year in three decades. There's a massive reset in valuations under way.

FIGURE 1. US AND GLOBAL STOCKS: CALENDAR YEAR RETURNS FOR THE PAST 30 YEARS



Source: Bloomberg. **Past performance is no guarantee of future results.** Indexes are unmanaged, do not include fess or expenses and are not available for direct investment.

The bond market hasn't fared well either, with its worst start in 30 years.

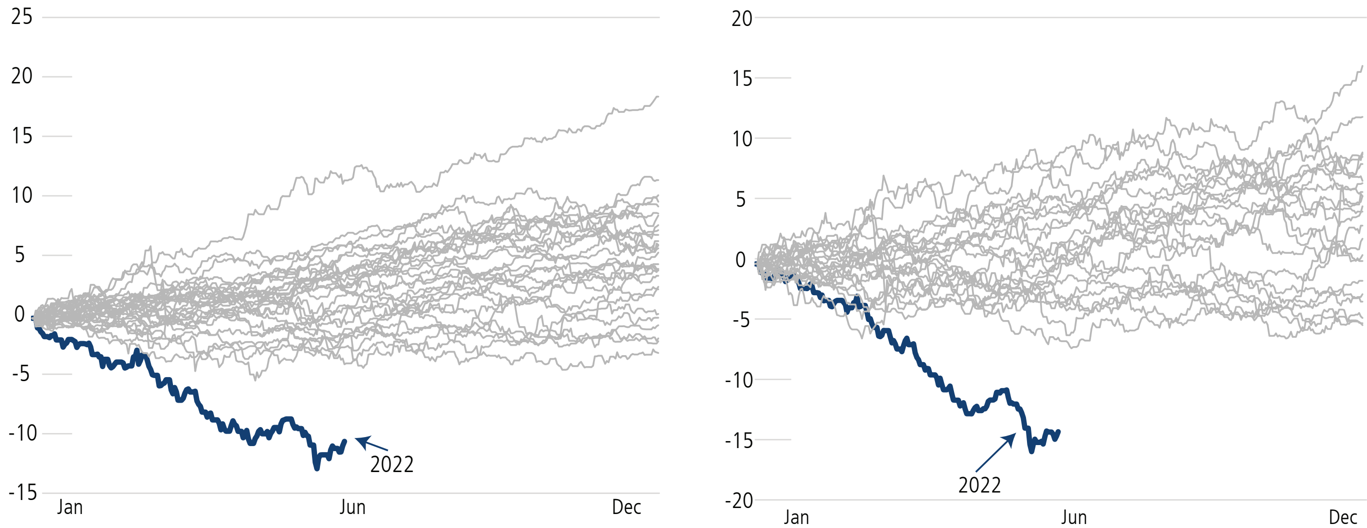
The bond market is also struggling as the Federal Reserve hikes short-term interest rates in an attempt to tackle inflation, which was once thought of as "transitory" but has been characterized more recently as "high" (Figure 2).

The convertible bond market has not been immune to the ills of the overall capital markets.

As equity and income markets struggle, convertibles also have faced headwinds (Figure 3).

FIGURE 2. US AND GLOBAL BONDS: CALENDAR YEAR RETURNS FOR THE PAST 30 YEARS OR SINCE INDEX INCEPTION

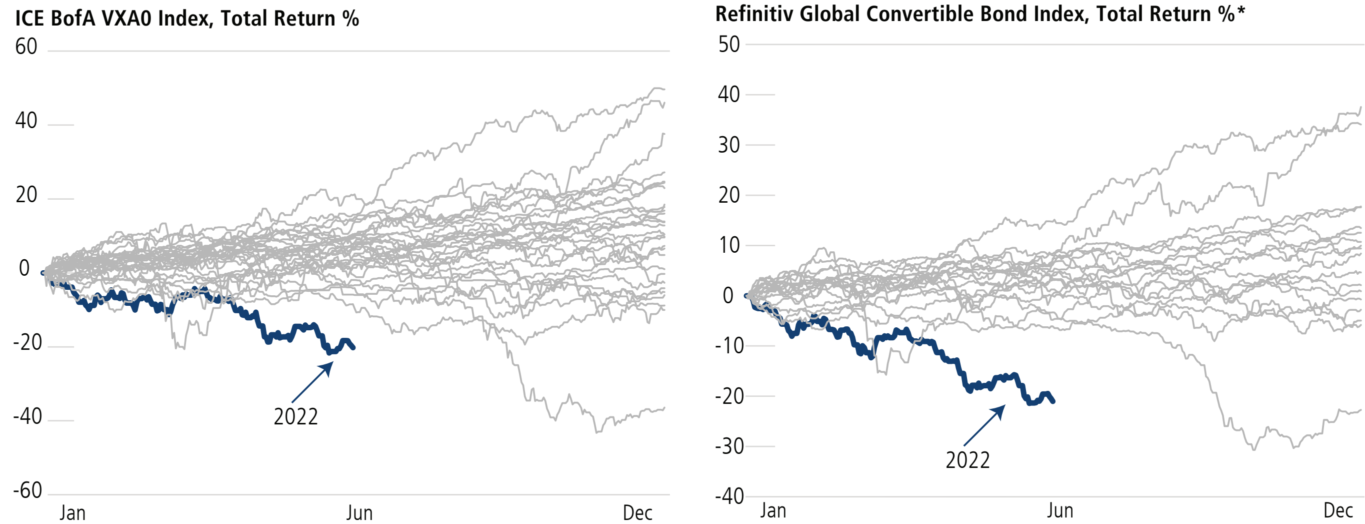
Bloomberg US Aggregate Index, Total Return % | **Bloomberg Global Aggregate Index, Total Return %***



Source: Bloomberg. **Past performance is no guarantee of future results.**

FIGURE 3. US AND GLOBAL CONVERTIBLE SECURITIES: CALENDAR YEAR RETURNS FOR THE PAST 30 YEARS OR SINCE INCEPTION

ICE BofA VXA0 Index, Total Return % | **Refinitiv Global Convertible Bond Index, Total Return %***



Source: Bloomberg. **Past performance is no guarantee of future results.**

*Returns for the Bloomberg Global Aggregate Index shown from 1999; returns for the Refinitiv Global Convertible Bond Index shown from 2004.

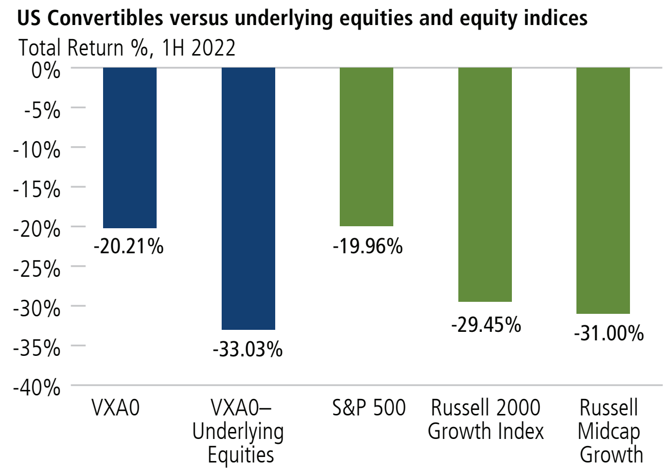
Small and mid-cap equities have faced more challenges.
In addition, investors have been giving thought to the relationship between the performance of the convertible market versus the overall equity markets. Whether we consider US convertibles relative to the S&P 500 Index or global convertibles relative to the MSCI World Index, convertible performance has generally been in line with the overall equity market.

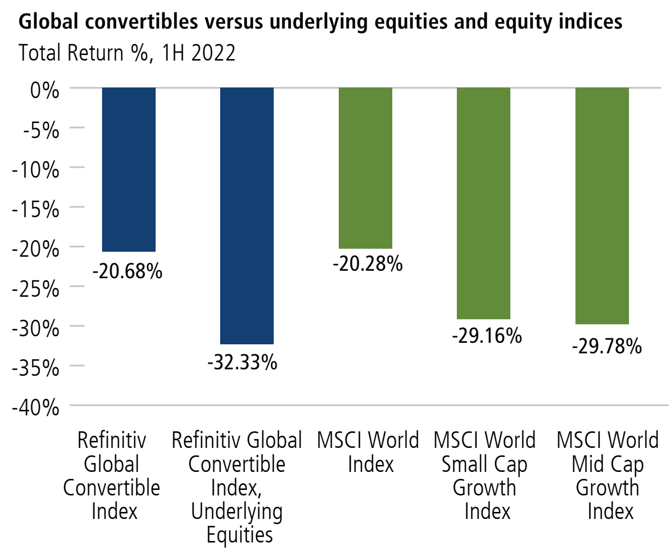
However, although those long-term relationships with broad equity markets are likely to persist, we believe it is important to evaluate convertible securities versus the equities of their underlying issuers. By that measure, convertible securities have held up better. Although equities have struggled across the board, it's still been a bifurcated market in which growthier and mid-to-smaller companies have struggled most (Figure 4). These are the sorts of companies that are the most well represented among convertible issuers.

The bond floors of many convertibles reflect the difficult environment for stocks and bonds.
Declining equity prices and widening credit spreads are pressuring the bond floors of convertible securities. For an extreme example, let's assume that the equity option attached to a hypothetical convertible security is thought of as worthless today. If that's the case, you are left with a bond that should pay you par at maturity. At what price should that bond trade in light of current bond conditions? It's very likely our hypothetical convertible security should trade down to a level where the yield to maturity is largely in line with securities available elsewhere in the market with similar characteristics (e.g., maturities or credit ratings).

With the effective yields of high-yield bonds in the 8.5% range as of midyear, that convertible should trade at ($78.5) if it had a three-year maturity. On the other hand, if that option still has value, our hypothetical convertible should trade at a higher price that incorporates the value of its option. If that option is "in the money," arguably, the convertible should trade above par value.

FIGURE 4. CONVERTIBLES OUTPERFORMED UNDERLYING EQUITIES, SMALL AND MID-CAP GROWTH INDEXES





Source: Bloomberg and Morningstar. **Past performance is no guarantee of future results.**

Today, a greater percentage of convertible securities are trading as what is commonly referred to as "busted" than we've seen in more than a decade (Figure 5). Busted convertibles have very low levels of equity sensitivity, which means their option value is quite far from being in-the-money.

Although the current amount of busted convertibles has risen significantly, there have been periods when an even greater portion of convertible bonds have had very low levels of equity sensitivity. After the technology, media, and telecom (TMT) equity market bust of 2000 and again after the Great Financial Crisis of 2008, we saw significant percentages of the convertible market trading at "busted" equity sensitivity levels.

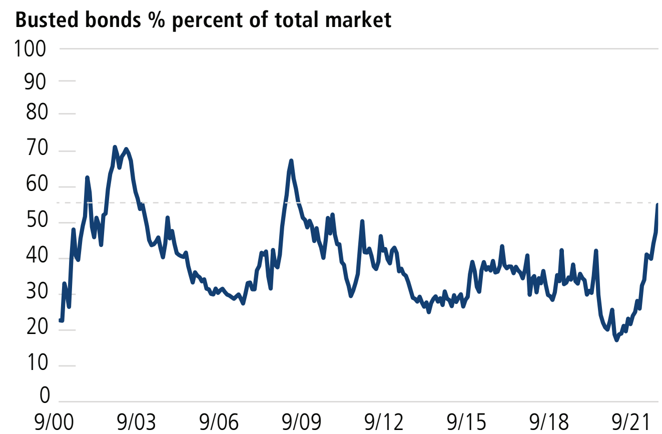
Although more convertibles have recently traded with lower bond floors than we had anticipated going into 2022, we believe this dynamic is more attributable to an equity valuation reset than a credit crisis. We will certainly keep a watchful eye, but below-investment-grade corporate credit spreads have held in fairly well and have not widened out to levels seen as recently as 2020.

In our view, the fact that credit spreads haven't widened out further reflects the strong fundamental characteristics of convertible issuers. Over the long term, defaults in the convertible market have been extremely low. The majority of issuers are well-capitalized companies with liquidity, and no near-term maturity walls. Additionally, the issuers of convertible securities in many cases have no other outstanding debt on their books, so they are sitting on lower cost-of-capital debt (and, in some cases, zero-coupon debt). In the US, 53% of the convertible market has no other debt, and globally that number is 48%. And in both US or global convertible markets, an even greater percentage of busted securities have no other debt (70% of US issuers and 62% of global issuers).

Tepid convertible issuance is part of a broader—and likely short-lived trend—in capital markets

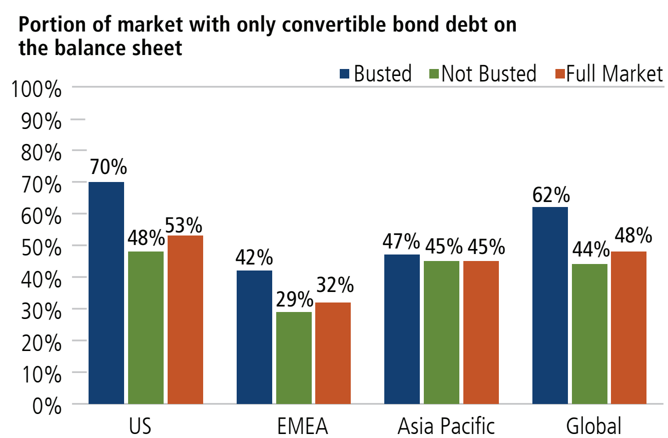
The decline in convertible issuance this year has given some investors pause. At $11.2 billion (USD) globally through June, convertible issuance has been anemic, but we also have seen little activity in the initial public offering market for common stocks or bond issuance in the corporate debt market. So what we are seeing is a capital market issue, not a convertible market issue. We believe it is likely that when the time is right, the convertible market will be ready and willing to support companies seeking quick capital with lower borrowing costs versus the traditional bond market.

FIGURE 5. BUSTED CONVERTIBLES HAVE RISEN TO LEVELS LAST SEEN IN THE GREAT FINANCIAL CRISIS



Source: BofA Global Research. Includes yield alternatives in the ICE BofA All US Convertibles Index, that is, convertibles with a long delta of less than 40%.

FIGURE 6. HALF OF CONVERTIBLE BOND ISSUERS ONLY HAVE CONVERTIBLE BOND DEBT ON THEIR BALANCE SHEETS



Source: BofA Global Research, ICE Data Indices, LLC. Data as of June 29, 2022.

Conclusion

The performance of convertible securities reflects the characteristics of the overall market environment, including declining equity prices, particularly for small and midcap growth names, and widening credit spreads as the Fed fights inflation. Additionally, we do not believe that the drop-off in issuance is a cause for concern, given the broader context of capital market activity.

Although convertibles have not been immune to the challenging conditions of 2022, they offer many opportunities for long-term investors. Today, convertibles are still an attractive means to take a more measured approach to the equity market. Also, convertibles have a shorter duration (about two-and-a-half years or less depending on the region), are trading at lower bond floors, and provide an option to the upside of their underlying issuers.

Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. The **S&P 500 Index** is considered generally representative of the US equity market and is market cap weighted. The **MSCI World Index** represents the performance of global equities from developed markets. The **MSCI World Small Cap Growth Index** captures small cap securities exhibiting overall growth style characteristics across 23 developed markets. The **MSCI World Mid Cap Growth Index** captures mid cap securities exhibiting overall growth style characteristics across 23 developed markets. The **ICE BofA All US Convertible Index (VXA0)** is a measure of the US convertible market. The **Refinitiv Global Convertible Bond Index** measures the performance of the global convertible market. The **Bloomberg US Aggregate Bond Index** and **Bloomberg Global Aggregate Bond Indexes** are broad-based benchmark of the US investment grade and global investment grade bond market, respectively. The **Russell 2000 Growth Index** measures the performance of US small cap growth stocks. The **Russell 3000 Value Index** is representative of those Russell 3000 Index companies with lower price-to-book ratios and lower forecasted growth values.

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