

# Fine-Tuning Exposure to Growth in Emerging Economies

March 2013

## EXECUTIVE SUMMARY

The growth opportunity emanating from emerging markets is profound and may represent the single most critical investment opportunity of the next decade and beyond. We believe this is an era of deep globalization and market integration, challenging investors to consider an unconstrained investment approach that capitalizes on the interconnectivity of businesses around the world. While emerging economies may be the most well positioned avenue to access macro growth trends over the next decade, allocating to emerging market equities continues to be an area that requires a focused and consistent evaluation of the risks, as well as the rewards.

We believe it is not sufficient to invest only in companies domiciled in emerging market countries to gain exposure to higher growth and higher expected return opportunities. A sound investment approach will need to identify the underlying drivers of growth and its beneficiaries, no matter where the company is located. This has been a guiding principle of our emerging market investment philosophy since inception of our portfolio. The objective of this paper is to discuss why our investment team believes a flexible and risk-managed approach improves the ability to access emerging market growth opportunities.

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## CALAMOS EMERGING MARKETS PHILOSOPHY: TEAM POINTS OF DIFFERENTIATION

- » Our investable universe includes emerging market-domiciled companies in addition to developed market-domiciled companies that generate a significant portion (generally 20% or more) of revenue or invested capital in emerging markets.
- » Applying decades of capital structure research to security selection, the Calamos investment team selectively invests in equity-sensitive securities, including convertible securities, as a means to participate in equity appreciation and potentially provide downside protection.
- » With respect to country exposure, a thorough analysis of the economic exposures of companies to various regions is a critical factor at Calamos. An emphasis on company fundamentals, and what we refer to as "revenue mapping," we believe, more accurately reflects business dynamics.
- » Another key aspect of a multi-dimensional approach to emerging market growth is the considerable attention our team gives to secular growth themes and how to access these themes across sectors and industries, as well as across geographies.

## EMERGING MARKET GLOBAL GROWTH DRIVERS

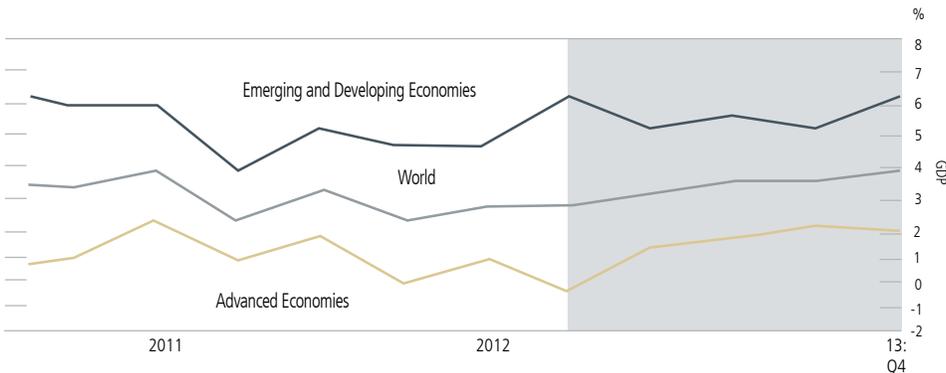
As developed markets face an extended period of deleveraging and fiscal adjustment, we believe emerging markets represent the critical growth engine for the world's economy. According to BofA Merrill Lynch, for every \$1 of global growth this year, emerging markets will contribute over \$0.80. Similarly, the IMF forecasts emerging markets will contribute more than three-quarters of global growth in 2012 and 2013 (Figure 1). Emerging market growth, of course, does not occur in isolation.

The global economy has become inextricably interdependent, and this presents both challenges and opportunities to global investors. The intersection of emerging market and developed market companies and consumers has perhaps never been so interwoven. Businesses, customers, employees, and various corporate functions, such as sales and R&D, emanating from any number of emerging and developed markets, represent both drivers of growth and sources of competition.

Emerging markets are often grouped together and discussed as a whole, but we believe it is important to consider that many countries, regions, and cultures comprise the emerging markets. In short, emerging market growth is not monolithic; it is multi-dimensional. This growth may take the shape of tremendous expansion of middle-class consumption in China, innovation in information technology services and related industries in India, abundant natural resource production in Russia and Brazil, and high-value manufacturing services in South Korea, for example. While the current pace of emerging market GDP growth may considerably outweigh that of developed economies, it too experiences periods of ebb and flow.

**FIGURE 1. GLOBAL GDP GROWTH**

QUARTER OVER QUARTER, ANNUALIZED



Source: World Economic Outlook, Growth Resuming, Dangers Remain, IMF, Jan '13, IMF Staff Estimates  
Past performance is no guarantee of future results

▸ In our view, it is not sufficient to invest only in companies in the emerging markets index to access higher growth and higher expected equity returns.

More recently, the focus for many emerging market central bankers has shifted from keeping inflation in check to supporting continued economic growth. Central banks in Brazil, China, and South Korea, among many others, have cut benchmark interest rates and reduced reserve requirements during the past year in an effort to stimulate growth. Many of these economies have considerably more capacity for policy support than developed economies due to their low public debt-to-GDP ratios and strong readings in related measures of fiscal health.

While emerging markets' population and productivity growth creates an attractive backdrop for long-term investors, we also believe this growth in itself does not guarantee satisfactory investment results. In our view, it is not sufficient to invest only in companies in the emerging markets index to access higher growth and higher expected equity returns.

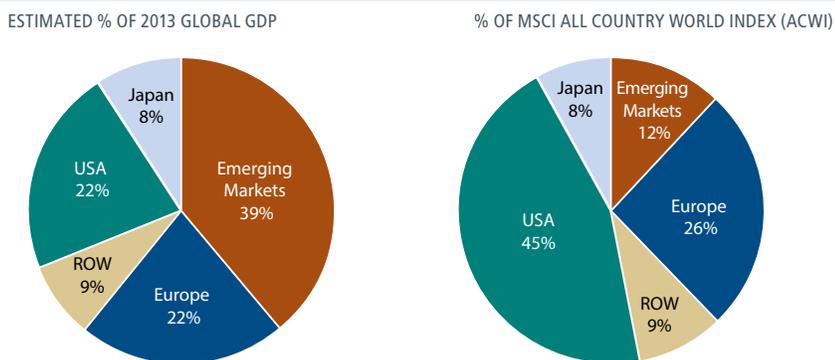
A sound investment approach is needed to identify the underlying drivers of growth and its beneficiaries, no matter where the company is located. From a big-picture perspective, many emerging economies are transitioning from export-led growth to a more balanced growth profile, with a greater contribution from consumer demand-driven growth and local infrastructure projects. With this in mind, we analyze which industries will reap the benefits of this transition and, further, which companies are likely to be leaders and laggards in this next growth stage.

## **INCREASING THE OPPORTUNITY SET**

We believe, therefore, investing in a universe defined by the emerging market index alone may be too blunt a tool for investors. Our active approach is not content to "take what the market gives us," instead it asks if there is an alternative or better way to access a growth trend. In cases where local capital markets may not provide sufficient access to a targeted growth area, a broader approach may benefit potential security selection.

Emerging economies may have already "emerged" in many respects, but their local stock markets are often significantly less mature. Perhaps the clearest illustration of this dynamic is that emerging markets account for approximately 35% to 40% of global GDP, yet these same

**FIGURE 2. % OF GLOBAL GDP AND % OF MSCI ACWI MARKET CAPITALIZATION**



Sources: International Monetary Fund World Economic Outlook, October 2012; Morgan Stanley Capital International and Calamos Advisors LLC. MSCI ACWI data as of 12/31/12.

regions account for less than 15% of global equity market capitalization, as reflected by the MSCI All Country World Index (Figure 2).

With respect to country exposure, our investment team pursues a more global and borderless approach to company analysis and portfolio construction. A strategy that invests only in local-domiciled companies may miss or underestimate the nuances of certain investment opportunities. A more flexible and unconstrained approach opens a larger investment universe and more accurately reflects business dynamics.

For example, a company based in Western Europe may actually provide more targeted access to the demand for improved power infrastructure in India, relative to local companies that may be overly diversified conglomerates or private companies out of the reach of most investors. We believe an advantage exists in the ability to actively select from more attractive business models and to exploit relative opportunities in stock prices and valuations.

As we have established, we believe this investment approach enhances our ability to access growth opportunities in emerging economies. More specifically, how does this premise impact idea generation and portfolio construction in our emerging markets portfolio? The Calamos investment team utilizes flexibility with respect to both geographic location and security type.

First, our team has the ability to invest in emerging market-domiciled companies in addition to developed market-domiciled companies generating a significant portion of revenue or invested capital in emerging markets.

Second, our team selectively invests in equity-sensitive securities, including convertible securities, as a means to participate in equity appreciation with potentially less equity downside. Because convertible securities include a fixed income component along with an option component (the right to convert into stock), a convertible may participate as the underlying stock appreciates but also may provide a cushion in the form of its bond value when the underlying stock declines.

Given the historic precedent for emerging market equities to experience significant and rapid sell-offs, we believe the attributes of convertible securities represent a structural advantage relative to an all-equity portfolio.

### **IMPORTANCE OF “REVENUE MAPPING”**

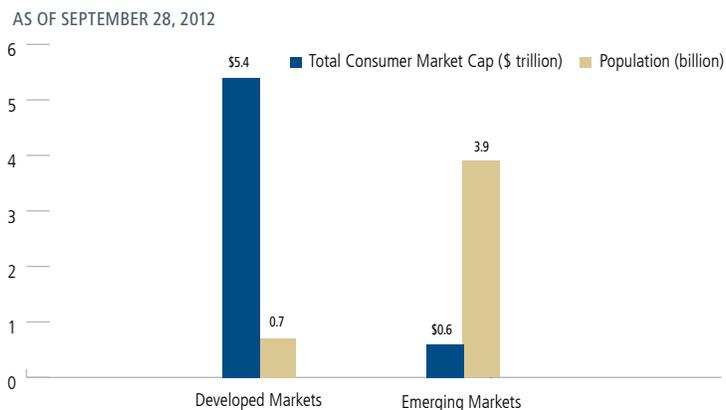
Given the inter-related nature of today’s global economic trends, we believe a thorough understanding of the economic exposures of companies to various regions has become a critical factor in security analysis and portfolio construction. An emphasis on company fundamentals, and what we refer to as “revenue mapping,” opens the path to a larger investable opportunity set. Broadly speaking, our team may invest in emerging market companies, emerging market multinational corporations (MNCs), developed market MNCs, and multinational affiliates operating in emerging markets. Our investment process is more focused on the level of exposure to growth in emerging economies than where a company is headquartered.

A key aspect of a multi-dimensional approach to emerging market growth is the considerable attention our team gives to secular growth themes and how to access these themes across sectors and industries, as well as across countries. From a fundamental perspective, we believe sector effects may be equally or more powerful than country effects in determining a company’s long-term growth opportunities and return on invested capital. For example, a Taiwanese company operating in computer hardware manufacturing services may see its business prospects more influenced by global PC demand, component pricing, and capital expenditure budgets than the economic conditions in its home market.

From a thematic perspective, the growth of middle-class consumption in emerging economies is a significant emphasis for our investment team. An estimated 1.8 billion individuals compose the global middle class, with approximately half of these residing in emerging markets (OECD, 2010). Perhaps most important to us, as growth investors, is the projected increase in emerging market consumption from approximately \$12 trillion in 2010 to \$30 trillion in 2025, according to McKinsey & Company. We have likely reached an inflection point where emerging markets no longer represent mainly complementary growth but rather the principal engine of global growth. As middle-class households proliferate and incomes rise, this will spur a transition from essential items to more discretionary goods. In our analysis, we are seeing the clearest effects of this transition already in categories including branded beverages, packaged foods, mobility devices, apparel and accessories, and education services, among others.

The critical question for our team is whether local companies and local markets provide adequate exposure to mega-trends such as this rising wave of income growth and consumption? Quite simply, no. Companies classified in the consumer discretionary and consumer staples sectors are the most direct beneficiaries of this middle-income sea-change. Yet, the combined market capitalization of these two sectors is almost \$600 billion in the MSCI Emerging Markets Index compared to over \$5 trillion in the MSCI World Index of developed countries. Compounded by the fact that the population in emerging markets is over five times the population in developed markets, the imbalance appears truly staggering (Figure 3).

**FIGURE 3. CONSUMER SECTOR'S MARKET CAP VS. POPULATION, DEVELOPED MARKETS VS. EMERGING MARKETS**



Source: BofA Merrill Lynch Global Equity Strategy

▀ We seek leaders with large or growing market share and high growth rates in industries that we believe are poised to take advantage of rising incomes in the emerging markets.

This scenario illustrates why our investment team believes a flexible approach adds value to active management. Accordingly, we utilize our ability to invest in global multinationals to gain exposure to the burgeoning emerging market consumer base. On the other hand, we also invest in local market-domiciled companies. We seek leaders with large or growing market share and high growth rates in industries that we believe are poised to take advantage of rising incomes in the emerging markets.

The demand for information anytime, anywhere is also a key secular theme for our investment team. This larger trend is contributing to rapid innovation in connectivity and mobility solutions globally. One specific impact on emerging markets is the exceptional growth in smartphones and related devices in emerging markets such as China, now the largest smartphone market and projected to experience 25% annual growth from 2011 to 2016 (IDC, August 2012).

Our team believes this demand trend will benefit a cross section of companies, from emerging market-domiciled companies to global multinational firms. It is not unusual for many of these companies to function as suppliers and competitors simultaneously; our multi-dimensional investment approach considers these complex relationships and evaluates the risks and rewards. For example, product “ecosystems,” such as the smartphone ecosystem, include emerging market players and global multinationals. To summarize, our approach to emerging economies utilizes greater flexibility because we believe this more closely reflects today’s business dynamics, enlarges our investable universe, and assists our objective to achieve better risk-adjusted returns relative to the emerging markets index over a complete market cycle.

Investors in our emerging economies strategy often seek additional research regarding the link between developed market multinationals and exposure to emerging economies. In short, they understand the benefits of our investment approach but they are interested in further evidence that it meets their emerging market investment objectives. MSCI published a white paper in May 2012, “Economic Exposure to Emerging Markets,” that serves as an informative resource.

The paper concludes that a strong positive relationship exists between the amount of economic exposure of developed market companies to emerging markets and the sensitivity of their stock returns to the excess return of MSCI Emerging Markets Index versus the MSCI World Index. In

short, companies generating a significant portion of revenue in emerging markets tend to have stocks that react more to movements in emerging markets than a typical company in the MSCI World Index. Over an almost 10-year period, from May 2002 to November 2011, companies with significant emerging market exposure also outperformed the global equities index and delivered better risk-adjusted performance metrics.

A second paper, published in 2012 by Professor Martijn Cremers,<sup>1</sup> found that publicly traded emerging market affiliates of large multinational corporations outperformed both their local stock market and the wider emerging markets over a 14-year period through June 2011. The affiliates combined this higher performance with lower volatility, especially lower downside volatility. Cremers cites improved corporate governance and a stabilizing role of the parent companies as contributing factors to outperformance.

Our holdings in affiliates of large multinational corporations have supported our risk-managed approach by combining the benefits of improved transparency and governance with the resources of multinational corporate ownership.

## RISK-FOCUSED IMPERATIVE

As discussed above, it is our belief that emerging economies may be the most well positioned avenue to access many of the dominant growth trends of the next decade. As emerging market equity plays a progressively larger role in asset allocation, a focused and consistent evaluation of the risks as well as the rewards remains paramount. Emerging market equities have generated higher returns than developed market equities over the past decade but also experienced higher volatility and larger drawdowns (Figure 4).

**FIGURE 4. DRAWDOWN, TOTAL RETURN AND STANDARD DEVIATION:  
MSCI EMERGING MARKETS GROWTH INDEX VS. MSCI WORLD GROWTH INDEX**

JANUARY 1, 2003 - DECEMBER 31, 2012

	MAXIMUM DRAWDOWN	ANNUALIZED TOTAL RETURN	STANDARD DEVIATION
MSCI Emerging Markets Growth Index	-61.44%	16.88%	24.13%
MSCI World Growth Index	-53.65	8.08	16.23

Source: Morningstar

<sup>1</sup>Cremers, Martijn, Emerging Market Outperformance: Public-Traded Affiliates of Multinational Corporations (February 23, 2012).  
Past performance is no guarantee of future results

▸ We believe our diversified emerging markets portfolio is structurally advantaged

Event risk and political risk have historically been a significant influence on emerging market performance. Two examples in recent years include the European debt crisis and the effects of the subsequent “risk-off” periods in global markets, and the Arab Spring and its accompanying wave of violent unrest. Both the European debt crisis flare-ups in the spring of 2010 and 2011 and the Arab Spring provided “stress tests” to our risk-managed approach to emerging market equities.

Additionally, the flow of funds into emerging markets has historically contributed to significant volatility. Cross-border capital flows, often referred to as “hot money,” can have a disproportionate impact on markets with less liquidity, lower levels of regulation, and considerably smaller total market value.

This is a key reason why emerging markets have often been considered a shorter-term tactical position. We believe our diversified emerging markets portfolio is structurally advantaged and provides targeted access to emerging markets revenue, earnings, and consumption growth while potentially reducing the risks posed by capital flows and sentiment change versus an emerging-markets only-investment portfolio.

## CONCLUSION

Given the outlook for population growth and gains in income and productivity, it is quite likely that emerging market economic growth will outpace developed market growth in the coming years. As multiple studies have established, however, higher economic growth does not simply translate to excess returns for equities.

Our team believes an investment approach targeting exposure to emerging economies, and not simply the emerging capital markets, has the potential to produce a more compelling risk-adjusted return across a complete market cycle. As the emerging economies mature, so too will secular themes develop and well-positioned companies benefit. We believe our risk-managed investment approach and a portfolio utilizing enhanced geographic and security type flexibility will be positioned to access this growth, no matter where it emanates.

## ABOUT CALAMOS INVESTMENTS

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Calamos Investments LLC is a diversified global investment firm offering innovative investment strategies including equity, fixed income, convertible and alternative investments, among others.

The firm offers strategies through separately managed portfolios, mutual funds, closed-end funds, private funds and UCITS funds. Clients include major corporations, pension funds, endowments, foundations and individuals. Headquartered in the Chicago metropolitan area, the firm also has offices in London and New York.

For more information visit [www.calamos.com/global](http://www.calamos.com/global).

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.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The index is calculated without dividends, with net or with gross dividends reinvested, in both US dollars and local currencies. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges. Investors cannot invest directly in an index.

The MSCI World Index is a market capitalization weighted index composed of companies representative of the market structure of developed market countries in North America, Europe, and the Asia/Pacific region. The MSCI World Growth Index measures the performance of those MSCI World companies with higher price-to-book ratios and higher forecasted growth values. The indices are calculated without dividends, with net or with gross dividends reinvested, in both US dollars and local currencies. Unmanaged index returns assume reinvestment of any and all distributions and do not reflect any fees, expenses or sales charges.

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 selected for the Fund's portfolio or the securities market as a whole, such as changes in economic or political conditions.

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.

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