



Prosperity Dispatch

EXCLUSIVE INTERVIEW WITH ONE OF THE MOST SOUGHT-AFTER FUND MANAGERS

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To say it's not often we get an opportunity like this is an understatement. Today we're sitting down for an exclusive one-on-one with the man the *New York Times* calls "*one of the most sought-after fund managers in the country...*"

In his ongoing quest to uncover hidden opportunities, get past the mainstream headlines to find safe investments, Andrew Mickey, Q1 Publishing's Chief Investment Strategist, had the opportunity to speak to John P. Calamos, Sr.

Calamos is the chairman, CEO, and founder of **Calamos Asset Management (NASDAQ:CLMS)**. The firm dates back to 1977 and has become one of the leading investment management companies in the world. As of March 2009, the firm managed \$23.5 billion in assets.

A big part of Calamos' success can be attributed to his firm's unique focus on risk and reward. He says that with convertible securities "*...investors can still be in the equity markets with less risk.*"

Long time Prosperity Dispatch readers are familiar with Calamos and the unique benefits and favorable risk/reward profile of convertible securities. At *Q1 Publishing*, we believe convertible bonds can provide the safety and downside protection of a regular bond, with unlimited upside potential, just like stocks.

So, who better to help us learn more about convertibles than John Calamos. In this exclusive interview, you'll learn:

- How you can use convertibles to your advantage
- The most misunderstood aspect of convertibles (90% of experts don't even get this one)
- John's approach to analyzing investments
- The investment he says hasn't been this cheap in decades
- What he's buying now

That's all just to get started. There's a lot more. And it's all included in the transcript below.

Enjoy,

Carly Walton

Publisher, [Q1 Publishing](#)

Interview with John P. Calamos, Sr. of Calamos Investments

Andrew Mickey: We've been covering convertibles for a long time. During times like these, it's tough to find a better investment with the right mix of safety and upside potential.

As you've been actively tracking, the recent downturn has decimated convertible bonds. So with everything that's going on with convertible bonds lately who better to talk to than yourself...

John Calamos: Thanks. Also, Andrew, I have Jeff Scudieri with me here. Jeff is one of our senior strategy analysts.

Andrew Mickey: First, I'd like to know how you became attracted to convertible bonds and how it all kind of came about?

John Calamos: Well, that goes back a long way. I had my MBA in finance and then went into the Air Force for five years flying airplanes. But I always had an interest in the financial markets. So my last two-year assignment was up in Minot, North Dakota. You can imagine what that's like.

Andrew Mickey: I was in the Air Force too and have heard about how "off the beaten path" Minot is, but I successfully avoided it. What did you do up there?

John Calamos: I was a pilot flying B-52s for Airborne Alert. That meant for four or five days at a time, you sat in a hole while waiting for War World III.

I started thinking, "Well, in case the Cold War never turns into something bigger, I better study my finance." So, it was while I was in the service that I studied and I really got enamored with convertibles.

And in 1971, my time was up. I got out and became a stockbroker. I started using convertible strategies or convertible securities back then. So that's how it all began for me.

The '70s were very volatile. I found convertibles to be a very good, attractive way to control risk in very volatile markets. So, I cut my teeth early on and continued along the path to convertible expertise.

Back in those days, option price theory was just coming out. The option market came into being in 1973 and Black-Scholes options models just came out in the '70s, too. As you know, option price theory then started being applied to other asset classes, including convertibles.

So early on, one of the first things we did was to really try and understand how option price theory is applicable to convertible valuation. In 1977, I started my own company investing in convertibles; and for the first 15 years in the business, we ended up being a boutique convertible institutional money manager.

Andrew Mickey: Interesting, you've come a long way since then. So to jump ahead a bit with

what's going on now, I want to get into the impact of hedge funds.

The *Wall Street Journal* says up to 95% of convertible securities are purchased by hedge funds.

Whether they use them for direct investment or convertible arbitrage, they buy a lot of them. But, with the recent redemption spree, a lot of them have had to sell out. Do you consider that a benefit to you as a buyer of convertibles or do you also engage in a lot of the arbitrage strategies?

John Calamos: We walk across a spectrum of convertibles, depending on the investment objective. We use convertibles in many different strategies: hedge strategies, long-only strategies and opportunistic strategies. We use busted converts, high-yield convertibles and convertibles as a defensive equity strategy.

We also have been doing convertible arbitrage for a long time. We have one of the few mutual funds that does convertible arbitrage. It's called the **Calamos Market Neutral Income Fund (CVSIX)**. It was opened back in 1990.

What it really comes down to is the investment objective and how you would use the convertible to help you fulfill that investment objective.

Jeff Scudieri: I think one of the opportunities that we saw here, with all the hedge fund activity, is that this selling was part of the process that pushed these convertibles down and made them look pretty attractive, based on undervaluation levels.

This happens when you have these hedge funds selling and having to raise money. That presented a pretty good opportunity because we could go out to the market and buy up some of these convertibles that they were selling.

John Calamos: Remember, we use convertible arbitrage just like the hedge funds do. We use it in that mutual fund I spoke about, but we don't do it on leverage. So it's a much more conservative strategy when used without leverage. It becomes a very aggressive strategy when you lever up four, five, six to one, like a lot of the convertible arbitrage specialists did.

As Jeff pointed out, these investors became forced sellers in the fourth quarter and created quite a bit of opportunity for us as buyers. In fact, we opened more of our convertible strategies to new investors.

Do these hedge funds and arbitrage specialists need to be there for convertibles to be a viable asset class? I don't think so. They don't have to be there, but they are. There are always a lot of interesting things going on in convertibles. There will be other people, like us, that continue to do convertible arbitrage so it's a temporary opportunity, but it's one worth taking advantage of.

We can't forget about one of the benefits of the hedge fund community in convertibles. They provide liquidity. But if they are not going to buy, you have market makers that have to provide liquidity. And because it's a very hedgeable type of security, you always have those types of people that will step into that space.

Andrew Mickey: That's a very good point.

Now, in a December 2003 interview with *Business Week* you said, "...we're avoiding some financial names. We also think things are somewhat overdone on the mortgage side of the housing market."

What about now? Where do you see some values? Industrials desperate for cash...international companies...medical companies?

John Calamos: Yes, we did say that very early on. Even early in 2008, we were avoiding a lot of the financial names and a lot of areas like housing. Unfortunately, nothing helped very much in the fourth quarter of 2008.

But what we've been looking at recently is our positioning. I still think technology has a role here. Companies will still continue to seek out ways to become more productive, manage margins better, etc.

We think technology was oversold in 2008, and as a result, has provided some good opportunities this year. Many of those companies have pretty good balance sheets, and we are looking at those opportunistically.

We do think globalization will continue. What we have been telling people is to think globally, think valuation, and think long-term. So we are looking for companies that have a broader global mandate—broader than just the U.S.

Convertibles are one way we think that investors can still be in the equity markets with less risk. It's kind of a defensive equity positioning strategy because convertibles are often cheap. You have the yield so you get paid to wait for something good to happen on the equity side. And you still have the bond investment. So, you still have the safety of the bond investment and you have the upside opportunity of the stocks.

For many investors, they want to stay in the market, but in a defensive fashion. We think convertible strategies make a lot of sense here.

Andrew Mickey: Yes, that makes sense. Now, what are the key differences as to focus on between convertible bonds and convertible preferreds?

John Calamos: Well, that's a good point. Convertible bonds are obviously higher up the ladder on the balance sheet. So if you had the choice between a convertible preferred and a convertible bond, you would always take the bond because the bond has a maturity day where a preferred does not.

With a bond, the company must pay you interest, and if they don't, it's a push towards bankruptcy. In contrast, a preferred is an equity position, so the company can actually pass the dividend.

But having said that, there are still very good opportunities in both convertible preferreds and convertible bonds. It really is company-specific as to what that opportunity is like. Often in the same company you don't have the choice between investing in a convertible bond or convertible preferred stock.

Andrew Mickey: With regards to your analysis process, do you look at their ability to repay

the debt first and then look at the equity potential separately, or do you kind of forego the equity altogether and if it works out, it works out. What kind of strategy do you use?

John Calamos: That's another good point. What we are really trying to get at is the intrinsic value of the company itself; and obviously, how much debt the company has on its balance sheet is really critical to that evaluation.

We take a very focused bottom-up view. We ask "how much leverages does the company have?" and "how have they used that leverage in the past?" We analyze that leverage to see how sure we are that they can pay it off and pay the interest payments.

We do our own creditworthiness work. We also want to know the intrinsic value of the business on the equity side. We want both sides of the defense: we want to be comfortable on the debt side but we also want to know how the debt helps the common stock grow.

Convertibles are the only type of bond that you have to care a lot about how well the equity does. A typical straight bond holder doesn't want the company to take any risks. He wants to make sure whatever they do, they make that interest payment. They want the rating to go up, not down, of course.

But a convertible holder, like Warren Buffett (who has been using convertibles in the last few months quite a bit) not only wants to get paid his interest, he also wants the company to use capital wisely so that the stock goes up, since the convertible can be converted to the underlying stock. So you do care about both sides of the equation.

Andrew Mickey: When it comes to companies issuing convertibles, we hear a lot about how companies have to offer very favorable terms to entice investors right now. And we hear about how some companies can't get financing altogether.

Now, some folks claim when a company issues convertible debt, it's more of an act of desperation and is a sign the company is having trouble raising money. Do you agree?

John Calamos: No, I don't think so at all. That is a very important misinterpretation of the convertible market.

It's your lowest cost of capital, in my opinion. It's lower than the cost of debt and it's lower than your cost of equity. You can either sell stock or you could borrow money in the bond market.

A company that's seeking capital today, by issuing their convertible, they are going to save 3% or 4% on coupon interest; and because they have a reduced coupon interest to pay, they are giving up equity at a 20% or 30% premium above the current stock price.

There are examples in history going back 100 years of how companies have built their businesses by issuing convertibles. So it is not a desperate act, it's really an analysis of the cost of capital.

If you think like a CFO and you say, "We need capital to continue to grow our business and if I go to the straight bond market—with the desperate hours right now—it might be a 10% or 11% or 12% coupon."

If I can issue a convertible at a 6% or 8% coupon and give up some equity, if it was successful, then

it makes a lot of sense. So it's not a desperate act at all.

In our opinion, growth companies as well as cyclical companies have used convertibles over the years very effectively in order to build their companies.

Remember what happens if you use your convertibles today. If you are successful and the company continues to grow, the equity goes up, the convertible will go up with the equity, and the company can call the convertible, which means that they force you to take a nice profit.

So it's a very effective means for companies to access capital, in our opinion.

Andrew Mickey: Alright, I had never heard that perspective. That's good.

John Calamos: The global convertible market is quite large. The U.S. is only 55% of the global convertible market, so it isn't a desperate act. There are a lot of investment-grade convertibles out there.

Andrew Mickey: You just mentioned the global convertible market. Are you looking for companies within specific countries...what approach are you taking?

John Calamos: It's a little bit of both, like our investment processes. When we are positioning our portfolios, even now, we do a little of the top-down work and combine that with the bottom-up analysis that we do on the companies. And we use a similar process when we are looking at different countries around the world.

Right now, we are looking to increase our exposure a little bit in Japan and Asia, those types of areas. We don't like what's happening too much in some of the Latin American countries, like Venezuela, and even what's going on with Russia and has been for a long time.

When we are looking at global convertibles, it's really a combination of where we would like to find exposure, and then doing a bottom-up analysis on those companies to see if we think they would make good investments.

Andrew Mickey: Let's take you back to spreads for one second. When you mentioned earlier where you said, "you kind of save 4% to 5% against the straight bond issue," with the recent downturn, are those spreads widening or are they shrinking where you don't get much of a discount with convertibles?

John Calamos: Well, as you can imagine, we didn't see a lot of issuance of anything in late 2008 and into 2009. However, issuance has picked up in March and April and terms have been very fair.

Over the years, it typically depends on the quality of the spread. Obviously, for a single B rated bond, it might be a wider spread than a AA bond, for example. The differential between the coupon of the straight bond and the convertible bond depends on the worthiness of the issuer.

As you can imagine, on average, about 400 to 500 basis points—or about a 4% to 5% differential—is what we typically have seen. And then, of course, the other critical item, the premium, is maybe on average, 20% or 35%. In other words, the exercise price would be 20% or 35% above the current

stock price at the time of issue.

Andrew Mickey: You have had the staying power for over 30 years. What has been your secret to success?

John Calamos: Well, like I said earlier, I have been doing convertibles since the early '70s. Our experience is in various market cycles—the '70s, the early '80s, the 1987 stock market crash, the 1990 recession or the 2000 recession. What has happened over those market cycles is that when the equity markets are going down, the fixed income characteristics of the convertible securities take hold. This provides that cushion on the downside.

As I said, we have been managing convertibles since the 1970s and since the 1980s for our institutional clients. During that period of time, we have had equity-like returns at significantly less risk, because of the downside protection in those recession years. I think that's why we feel strongly that convertibles provide a defensive equity strategy for investors.

Andrew Mickey: Currently, with convertibles, can you comment on all the safety features you talk about?

John Calamos: Yes, and I think these are even more pronounced in this kind of volatile market environment.

Convertibles are extremely undervalued. I mentioned we did work using option price theory, and based on this theory, they are the cheapest I have ever seen them.

In late 2008, we calculated that overall, convertibles were 11%, 12% below their fair value price. The debt typically reverts back to fair value over time. During 2009, valuations have improved, but convertibles are still very cheap in here.

Many convertibles are trading below their fixed-income equivalent and almost half the issues are below their bond values. So you get the bargain there and you still have the upside. So the upside opportunity relative to the downside risks is extremely favorable right now.

For investors, I think it's particularly important, Andrew, because in this market what everybody is trying to figure out, including us, is when does this market turn?

If you can have a strategy that says, "okay, I am in the bond market; I'm getting paid interest income; I have a maturity less than five years; and when the market turns I am going to participate...and I don't have to make that market decision." The toughest decision individual investors have to make in this market is the market timing decision, and that is not really clear.

Just a few weeks ago, the GDP numbers that came up were the worst GDP numbers since 1982. What people forget—but what I remember well—is that in August of 1982 a five-year bull market began that compounded at 18%, 19% annualized.

Markets don't turn when everything is okay.

So, if you didn't have to make that timing decision, that's an advantage. We think that's one of the

benefits of a well-managed convertible strategy.

Andrew Mickey: Thank you so much for your time. I think a lot of readers will get a lot of value from this.

John Calamos: No problem. Thank you.

There you have it. I hope this provides a good bit of help to all of you in your search for new investment opportunities. There are plenty out there, but few can rival the inherent safety and the high levels of rewards of convertible securities.

For anyone interested in learning more about the unique opportunities created by convertible securities, it's one of the market opportunities we follow closely in Andrew Mickey's 100% free e-letter, the *Prosperity Dispatch*.

To learn about how you can get a complimentary subscription and the types of benefits many other readers are taking advantage of, simply visit our website at www.Q1Publishing.com

Regards,

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