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Calvert Navigates the Current Bond Market

Greg Habeeb is the lead portfolio manager for Calvert's taxable bond funds, including Calvert Ultra-Short Income Fund and Calvert Short Duration Income Fund. Here he discusses recent market volatility and how nimble trading and duration management have helped Calvert weather the market's ups and downs.

The European debt crisis has created significant market uncertainty. Have you made any changes to your strategies as a direct result of the mounting worries about sovereign risk?

At times during the first quarter, fears that Greece and some of its neighbors in the euro-zone would default on their sovereign (or national) debt put significant downward pressure on the markets. By this spring, the sovereign risk issue in Greece had escalated to a crisis of potentially large proportions. While the long-term impact of the sovereign risk issues on the global economy is still uncertain, investors will likely remain cautious until there's more clarity about the specifics of Europe's bailout package and whether it can successfully contain the crisis.

We don't hold the sovereign debt of the euro-zone countries, so the crisis hasn't had a direct impact on us. Of course, the market's general anxiety about sovereign risk has caused some very significant secondary effects—the most obvious of which has been investors' flight to the greater safety of U.S. Treasuries. The yield on the 10-year Treasury dropped from 4.00% on April 5, 2010 to just less than 3.40% on May 6 as investors worried about the ability of European governments to contain

the crisis flocked into Treasuries. Overall, the situation has created significant volatility in Treasuries, which we like and strive to take advantage of through active trading of Treasuries or Treasury futures. Our investment strategy is very dynamic—we're constantly monitoring and adjusting our duration and curve exposure in order to benefit from interest rate volatility.

Do your active trading strategies extend to corporate bonds as well as Treasuries?

In terms of our holdings of corporate bonds, our investment approach continues to emphasize holding fundamentally strong U.S. corporate securities that we believe have been mispriced by the market. The sovereign debt crisis has also created volatility in the corporate bond market, and we've tried to take advantage of that by buying bonds whose prices appear to have been driven down to levels below what we think their fundamental financial strength dictates. Conversely, we are also always looking for opportunities to sell bonds that have appreciated in price if we find other securities in the market that offer more relative value.

A good example of our nimble trading in corporate bonds occurred on May 6, which is the day of the "flash



crash” in the stock market. Treasuries rallied strongly that day, and credit spreads¹ generally widened as investors demanded more yield to take on any credit risk. We were able to react quickly to that day’s downturn in the corporate bond market and capitalize by purchasing several attractively priced issues. In terms of one specific fund, we reduced the cash position in Calvert Ultra-Short Income Fund from 15% to 12% on that day to buy corporates that had been beaten down in price.

How are you positioning your funds in terms of duration?

Our duration² strategy generally involves maintaining a shorter-than-benchmark duration when rates are low to help mitigate the effects of rising rates. We gradually extend duration when rates climb to the point that the risk-reward tradeoff becomes more positive. Over the past 52 weeks, the yield on the 10-year Treasury rose from a low of 3.08% to a high of 4.00% even though the Federal Reserve had not raised rates. Twelve months ago, the durations of

our funds were much shorter than the durations of their benchmarks—we’ve extended our duration remarkably since then and we’re still shorter than our benchmarks.

For example, at the beginning of 2009, the duration of Calvert Short Duration Income Fund was 0.75 years. We lengthened it to 1.06 years as of the end of the first quarter to take advantage of the improving risk/return profile going forward. For comparison, the duration of the Fund’s Lipper benchmark was 2.83 years on the same date. The duration of Calvert Ultra-Short Income Fund is very close to zero right now.

We’re very comfortable with our current duration positioning for a couple of reasons. First, we use corporate floating-rate securities as a way to partially protect the portfolios from the price risk associated with rising rates and also to participate in their rising coupons as interest rates move higher. Second, we actively participate in the Treasury futures market as a way to

try to profit from short-term interest rate changes through duration and yield curve management. In addition, Treasury futures sometimes represent a less expensive way to implement a particular yield curve or duration strategy than using “cash” Treasuries.

Do you think that there is currently a bubble in the corporate bond market?

A few weeks ago I might have said that. At that point, it seemed like the credit market had rallied too far and too fast in light of the condition of the domestic and global economies. However, credit spreads were much narrower in 1998 and again in 2007 than they are now. With that said, having been in the bond market for over thirty years now, with enough advance preparation I think that we can successfully navigate our portfolios around bubbles through diversification among the various sectors of the bond market as well as nimble trading between those sectors. ■

1. Credit spreads measure the difference in yield between a corporate bond and a Treasury security with a comparable maturity.

2. Duration measures a portfolio’s sensitivity to changes in interest rates. Generally, the longer a portfolio’s duration, the greater the change in price for a given change in interest rates.

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Calvert Ultra-Short Income Fund and Calvert Short Duration Income Fund are subject to certain risks including interest rate risk and credit risk. As interest rates rise, bond prices generally decrease. The prices of long-term bonds are more sensitive to changes in interest rates than the prices of short-term bonds. Therefore, in general, long-term bonds have more interest rate risk than short-term bonds. In addition, the credit quality of the securities may deteriorate, which could lead to default or bankruptcy of the issuer where the issuer becomes unable to pay its obligations when due.

The value of a futures contract tends to move in tandem with the value of the underlying instrument, can be highly volatile, and the potential loss from futures can exceed the Fund’s initial investment in such contracts.

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