MERGER ARBITRAGE

SAM

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INTRODUCTION

We believe successfully navigating today's markets is a colossal task.

Over the last several decades, we've witnessed the painful dynamic that increased market volatility wreaks havoc on most asset classes. Whether it's the Dot-Com Bubble of 2000 or the Great Financial Crisis of 2008 or the Covid-19 Pandemic of 2020, nearly all investment strategies suffered significantly during those turbulent times.

The 60/40 "Balanced" portfolio, consisting of both stocks and bonds, has long been revered as a trusted guidepost for the moderate investor. Nevertheless, in 2022, this established methodology had one of its worst years on record as both sides of the portfolio came under pressure.

So what is an investor to do? During a market maelstrom, the few asset allocations that perform relatively well are the ones that exhibit low correlation to the overall markets.

At SAM, we assign considerable thought to how we have formulated our strategic bedrocks of asset allocation. Each one of them possesses a comprehensive array of investment principles that we believe should collectively shepherd our portfolios during a typical market cycle, particularly during bouts of heightened instability.

The asset allocation bedrock we would like to highlight is Merger Arbitrage, an idiosyncratic investment blueprint that large multi-strategy hedge funds have successfully implemented for their institutional clients. Investment returns related to this unique strategy are driven by the outcome of the specific transaction, rather than the direction of equity or bond markets.

Since our inception, we've managed to implement this low-correlation strategy for SAM clients with considerable achievement.

MERGER ARBITRAGE: WHAT IS IT?

When a corporate acquisition is announced, perhaps the most important facet to understand is that a legal obligation is assumed by the acquiror to purchase the target.

Consequently, the stock of the acquired company usually jumps up and closes the day at a price very close to the acquisition price, but oftentimes a bit lower. The difference between the acquisition price and the market price is oftentimes called the deal spread.

Now—Why does this deal spread even occur? There may be antitrust concerns if two corporate entities in the same space are merging, or there may be financing concerns if the acquiror may not be able to raise the required capital to complete the deal.

Because of the typically strong language that governs a legal document called the Merger Agreement, approximately 94% of public U.S. mergers over time have successfully closed[1]. Therefore, investors who purchase the stock of a company that is being acquired are attempting to capture the deal spread of a corporate transaction with a historically high success rate of completion.

1 Source: Merger Arbitrage: A Strategy for Consistent Profits in the Market -- AccelerateShares, Aug 2019

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MERGER ARBITRAGE: TEXTBOOK EXAMPLE

In late October 2018, IBM announced the acquisition of software provider Red Hat for $190 cash per share, which represented a 63% premium over Red Hat's prior closing price of $116.68.

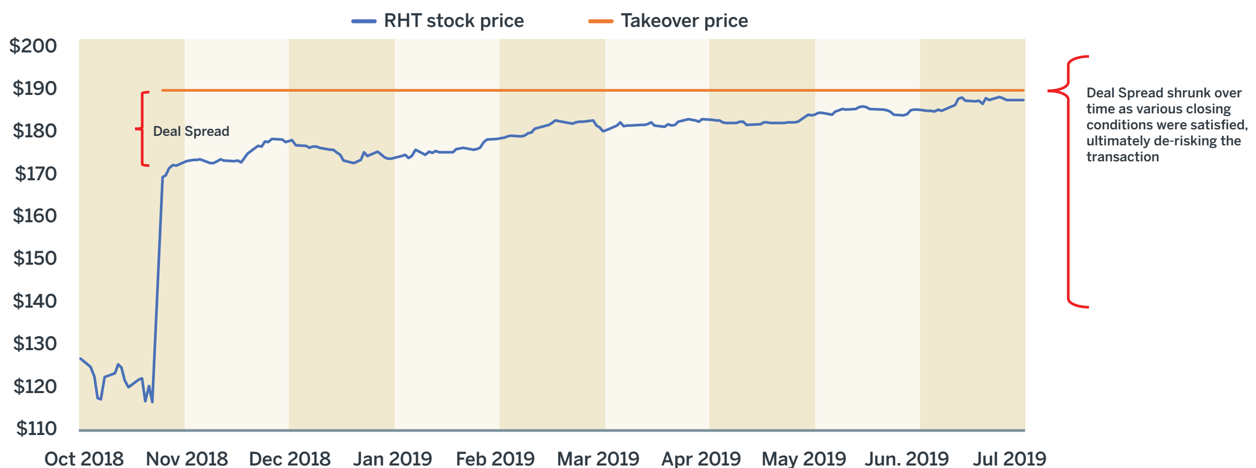
When the deal was announced, Red Hat quickly rose from $116.68 to $170 per share, still well below the $190/share deal price, which reflected a 12% discount (or spread) to the actual takeover price.

Thus, the $20 spread between the $170 price per share and $190 deal price created a merger arbitrage buying opportunity.

Ultimately, the deal closed on time and without any incident in early July 2019. Investors who bought Red Hat stock when the deal was announced would have earned 12% over the subsequent 8 months, or an annualized ~17% return. [see graphic below]

In our opinion, the Red Hat acquisition is a textbook example of how an investment manager can exploit a positively asymmetric Merger Arbitrage trade for their clients.

Red Hat Acquisition Timeline



Source: Bloomberg

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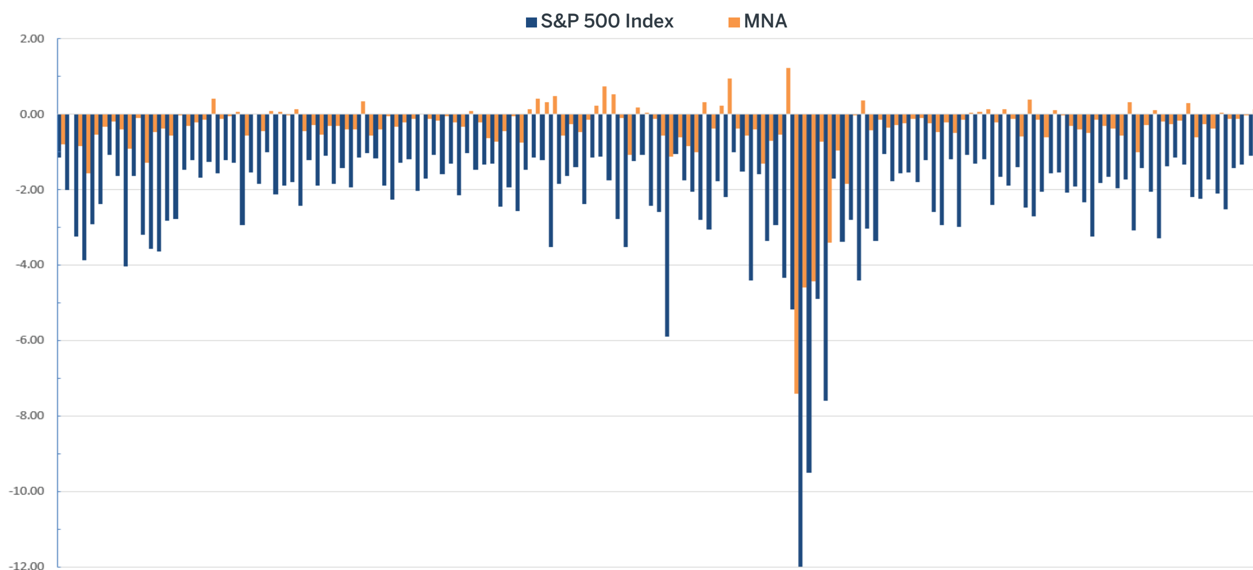
MERGER ARBITRAGE: LOW CORRELATION TO EQUITIES

Earlier, we described Merger Arbitrage as possessing powerful idiosyncratic investment characteristics. But just how favorable are they? They are perhaps best exemplified during periods of extreme equity market volatility.

As you can see in the graphic below, there are days when the S&P 500 has dropped at least 1% over the last 5 years, which is denoted by the blue bars.

Days When the S&P 500 Index Dropped at Least 1% Over Last 5 Years



Source: Bloomberg

The important thing to note is that the drawdown of the Merger Arbitrage ETF, as seen by the orange bar, was only a fraction of the overall market drawdown.

In fact, there were several instances where Merger Arbitrage managed to generate positive returns despite a down market! How is this even possible?

Well, remember that absent any litigation, mergers and acquisitions are contractually obligated to close at the agreed-upon price. So, despite a significant drop in equities, Merger Arbitrage investments held their ground and even managed to squeeze out a small gain. Thus, well-managed exposure to this specific asset allocation provides an optimal hedge during periods of distress, while also providing potential for meaningful upside as well.

All of which is simply a testament to the notion that this particular strategy can generate meaningful outperformance in a myriad of market conditions.

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MERGER ARBITRAGE: LOW CORRELATION TO FIXED INCOME

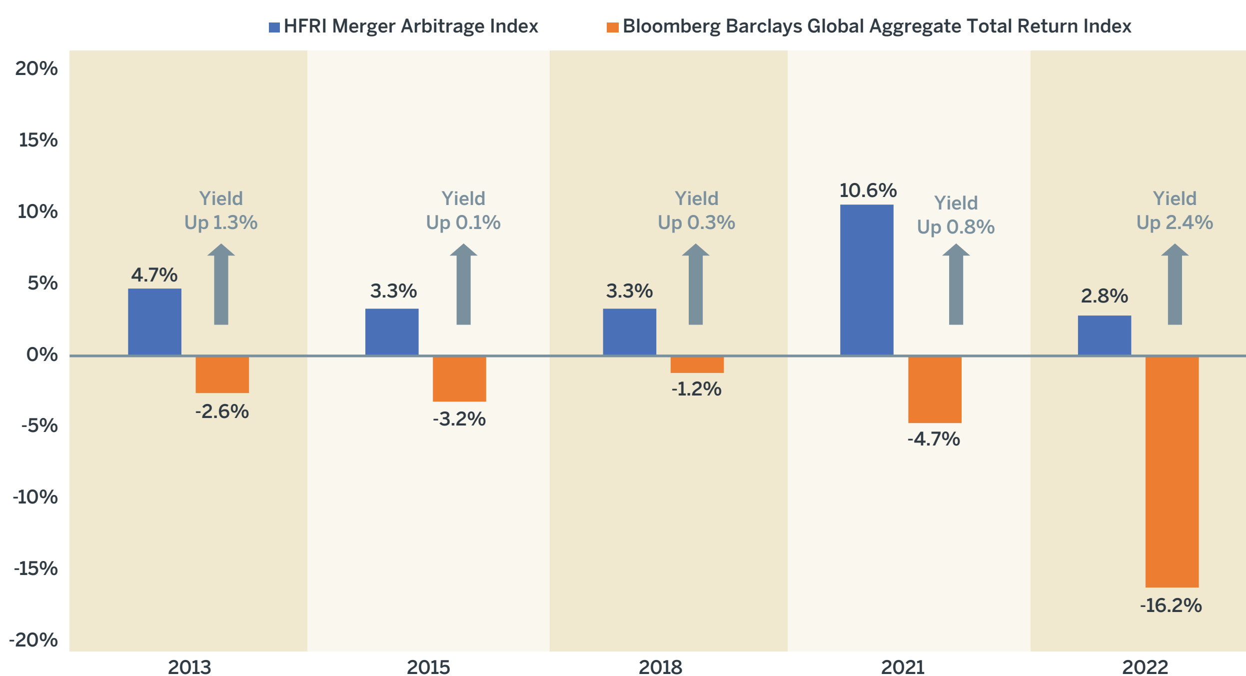
Another material benefit is that Merger Arbitrage can provide positive returns in a rising rate environment—a scenario on possibly every income investor's mind.

Over the past decade, there have been five years in which 10-year Treasury yields have risen and the Global-Aggregate bond index has lost money.

As interest rates rose in 2013, 2015, 2018 and 2021, bonds lost money. Meanwhile, Merger Arbitrage provided positive performance. [see graphic below]

We now know that 2022's Treasury sell-off was unprecedented. Yields rose substantially and as a result, all fixed income got crushed, down more than -16%. Yet, despite the interest rate headwinds, Merger Arbitrage generated a 2.8% positive return across the entire index.

Years When 10-yr Treasury Yields Rose Over the Past Decade



Source: Bloomberg

CONCLUSION

Unfortunately, textbook Merger Arbitrage examples are few and far between. Many of these investments possess specific nuances that separately influence the deal spread, which therefore requires a manager with a deep and broad investment acumen.

At SAM, through decades of experience, we've amassed the skill-set necessary to successfully navigate this strategy. Time and again, we've demonstrated that SAM can profit from capitalizing on this deal spread by painstakingly analyzing the specific dynamics of each corporate acquisition.

At the end of the day, Merger Arbitrage lays the foundation for substantial uncorrelated returns, which is an extremely compelling proposition—especially in a market environment where overall volatility is spiking and so many assets move in tandem with one another.

SAM Merger Arbitrage Analysis Framework

Deal Spread Components

- Regulatory issues/hurdles
- Financing conditions and agreements
- Shareholder voting concerns
- Litigation risk
- Expected time to close
- Risk-free rate (e.g., U.S. T-bills)

SAM Initial Due Diligence

- Estimate the probabilities of an antitrust investigation and subsequent enforcement action.
- Scrutinize the potential for acquirer termination.
- Consider material adverse changes to either party.
- Evaluate financing concerns.
- Examine any shareholder resistance.
- Conceptualize other risk factors resulting in a deal delay.

SAM Deep Value Edge

- Diligently review Merger Agreements w/expert outside counsel.
- Confer w/ extensive network of institutional professionals to gain deeper market insight.
- Speak to industry contacts to assess rapidly evolving U.S. regulatory/political landscapes.
- Monitor comparables for earnings and/or other events via Bloomberg that are impactful.
- Constantly re-assess downside risks from a macro and/or company perspective.
- Adjust position sizes around timeliness of significant merger milestones.

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Interested in Learning More?

A SAM colleague would be more than happy to walk you through how we help clients achieve their long-term financial goals every day.

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Mario is a Portfolio Manager and Deputy Chief Investment Officer at SAM. He is responsible for sourcing and monitoring positions across the firm's strategies, while also serving as a principal spokesperson for the team's investment philosophy with clients.

Prior to joining SAM, Mario was the Director of Investment Grade Research at Zazove Associates, a multi-billion dollar investment firm specializing in convertible securities management. He was previously a Senior Credit Analyst at Sandelman Partners, a multi-strategy hedge fund focused on fixed income relative-value investing. Mario started his buy-side asset management career with Citadel in 2001, where he was one of the first credit research analysts hired into the Convertible Arbitrage group.

Mario holds a BA from Stanford University where he majored in Economics. He has also completed graduate-level coursework in Statistics & Data Science at The Massachusetts Institute of Technology. Mario earned the Chartered Financial Analyst (CFA) charter in 2011, and currently serves on the Board for the CFA Society of San Francisco.

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