AXS Education Series

MERGER ARBITRAGE

An Introduction

"Merger arbitrage deserves a closer look as a strategy that can provide investors with a solution to reduce volatility in a portfolio"

Developed in partnership with

KELLNER Capital

The need is quite simple.

With market uncertainty being the only certainty, there is a growing need for investors to diversify their portfolios.

Investors are seeking return streams that are uncorrelated to the broader markets. In fact, most "traditional" asset managers now acknowledge that the time-honored 60/40 stocks and bonds model is in need of some modernization. Against such a backdrop, merger arbitrage deserves a closer look as a strategy that may provide investors with a solution to reduce volatility in a portfolio.

What is Merger Arbitrage?

Merger arbitrage describes an active trading strategy that utilizes equities in an effort to capture the expected profit between the current market price and the value to be paid at the close of a publicly announced merger or acquisition.

When a publicly traded company is the target of a takeover, there is often a "spread" between the offer price (the price to be paid at closing by the acquirer) and the trading price immediately following the deal's announcement.

Typically, the target company's stock trades at a discount to the announced deal price. The discount results from:

1. the risk that the transaction will fail to close, and
2. the time value of money

A merger arbitrage strategy attempts to capture this spread to earn a consistent return stream. This strategy is typically employed by taking long positions in the stocks of companies that are the target of announced M&A transactions. See the hypothetical example of a merger arbitrage spread described in Exhibit 1.

EXHIBIT 1: Merger Arbitrage Spread

Company ABC announces a $147 cash offer to acquire Company XYZ, which is currently trading at $140.

$147 target price at deal close
- $140 target price today
$7 spread

The **percentage return** in this situation would be:

$$\frac{\text{Spread}}{\text{Current price}} = \frac{\$7.00}{\$140.00} = \mathbf{5.00\%}$$

Assuming four months to close, the **annualized return** (12/4 months x 5.00%) on the deal is 15.00%.

The **annualized return** assuming four months to close the deal would be:

12 mos./4 mos. x 5.00% = **15.00%**

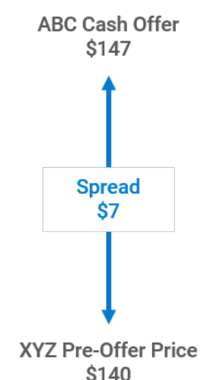
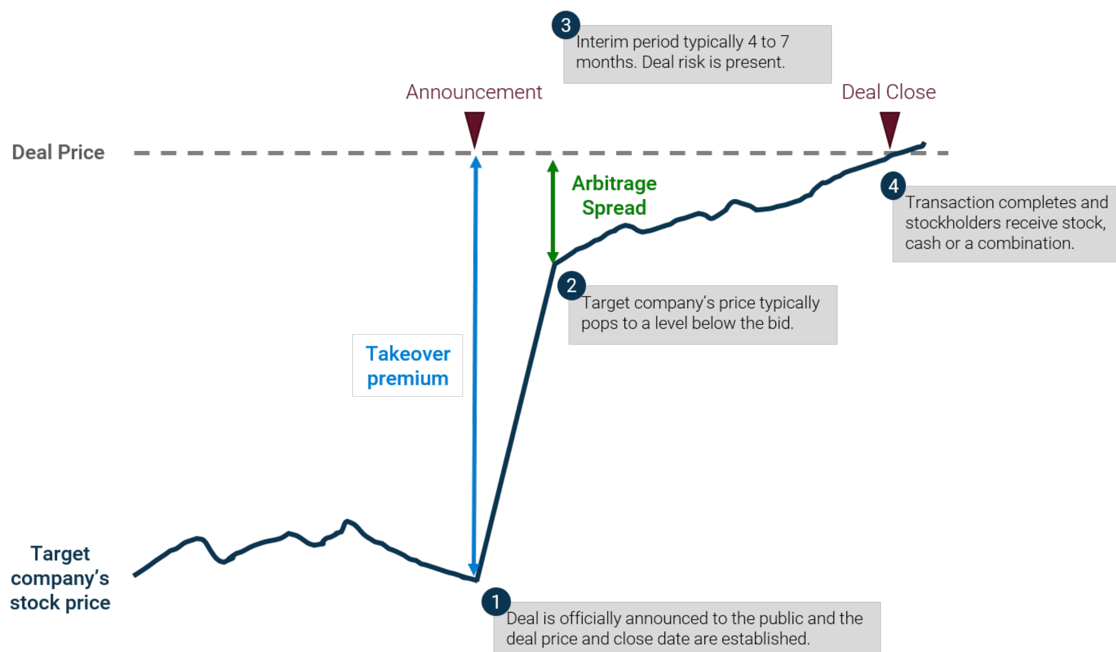


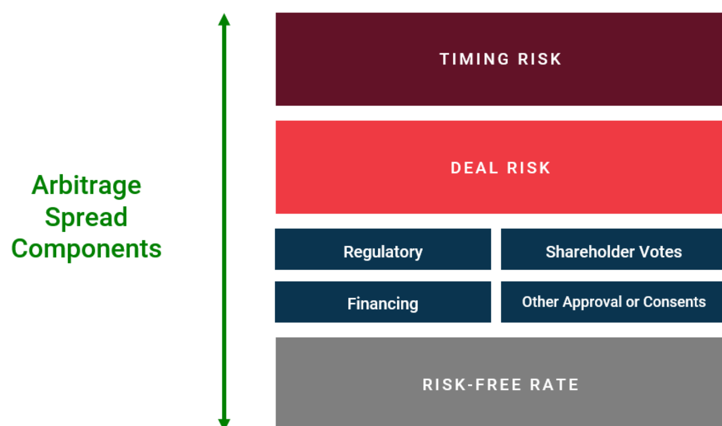
Exhibit 2 below illustrates a typical deal over time from pre-announcement through completion.

EXHIBIT 2: Overview of a Merger Deal



Merger arbitrage strategies profit from the arbitrage spread, which equals the risk premium plus the risk-free rate. Several factors figure into the risk premium as shown in Exhibit 3, including variables that may affect the deal and the time it takes to close the transaction.

EXHIBIT 3: Merger Arbitrage Spread Components



Overall, a merger arbitrage investor relies on the robust effort and processes around deal selection and ongoing monitoring in an attempt to create more winning positions than losers and, therefore, generate the potential for significant profit over the long run. In addition, while past performance is not necessarily indicative of the future, the strategy relies on the fact that, at least historically, **greater than 90% of publicly traded mergers have been taken to completion**, according to data from Bloomberg.

Why Add Merger Arbitrage to an Investment Portfolio

In practice, merger arbitrage offers four potential benefits within the average investor's portfolio. The strategy can be employed as:

1. a market neutral total return strategy
2. an alternative to fixed income
3. an effective interest rate/inflation hedge, or
4. an overall portfolio diversifier.

Historically, merger arbitrage strategies have exhibited low levels of correlation to the equity market. This makes sense when one considers that merger arbitrageurs are anticipating the probable outcomes of specifically identified transactions instead of predicting the far more random investment variables that move the broader equity market. Furthermore, merger arbitrage strategies offer a relatively straightforward way for an investor to introduce some degree of market neutrality into a portfolio.

The performance and correlation statistics of merger arbitrage and the S&P 500 over 30 years are outlined in Exhibit 4 below.

EXHIBIT 4: Performance Statistics (January 1, 1990 to December 31, 2020)

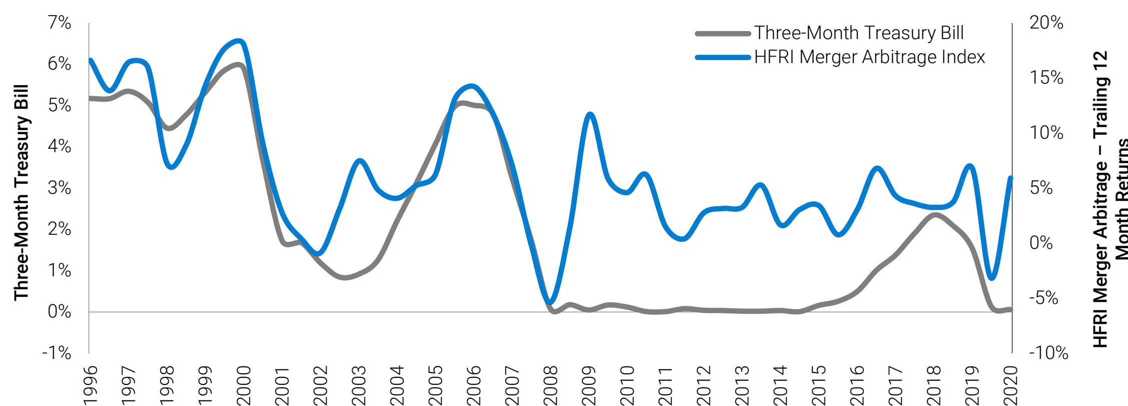
	Annualized ROR	Standard Deviation	S&P 500 Correlation	Max. Drawdown	Worst Month	Sharpe Ratio
HFRI Merger Arbitrage Index	7.39%	4.31%	0.55	-10.89%	-9.58%	1.08
S&P 500 Total Return Index	10.23%	14.69%	1.00	-50.95%	-16.79%	0.51

A well-executed merger arbitrage strategy can offer an attractive alternative to a fixed income allocation. Since merger arbitrage spreads are comprised of the cost of capital plus a risk premium, a low-risk merger arbitrage strategy has the potential to deliver consistently higher returns than the three-month Treasury bill on an unlevered basis.

Further, when rates begin to rise, merger arbitrage returns are likely to rise along with the three-month Treasury bill. As such, a merger arbitrage strategy can provide a natural hedge to increases in interest rates or a bout of inflation. Exhibit 5 highlights the historical ability of merger arbitrage returns to mirror or exceed short-term treasuries.

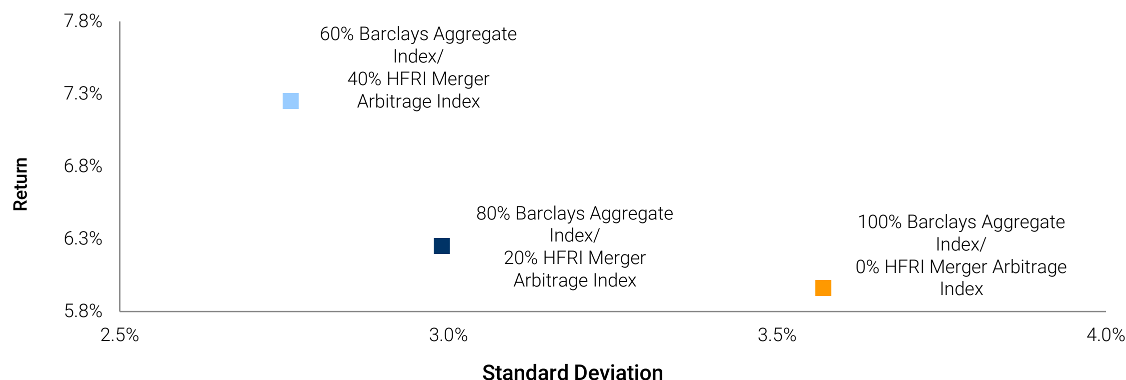
EXHIBIT 5: Three-month Treasury Bill vs. HFRI Merger Arbitrage Index

Trailing 12 Month Return (From December 31, 1996 to December 31, 2020)



Merger arbitrage strategies tend to exhibit a low level of correlation with the overall market. They also offer real potential as an effective diversifier within a balanced portfolio. Because variations in returns on individual investments may reduce the variance of returns on an overall portfolio, portfolio risk is primarily a function of the degree of variance of an additional investment compared to the portfolio as a whole. As such, an allocation to merger arbitrage offers the potential to enhance the overall portfolio returns, while lowering volatility. Exhibit 6 outlines the historical performance of various portfolios that include an allocation to a merger arbitrage strategy.

EXHIBIT 6: Index Risk vs. Return
(From January 1, 1990 to December 31, 2020)



Five Things to Remember about Merger Arbitrage

1. Has historically shown low correlation to the broader equity markets and significantly less volatility.
2. Has the potential to deliver consistently higher returns than the three-month Treasury bill.
3. Has positive correlation to interest rates making it an effective hedge to portfolios in a rising rate or inflationary environment.
4. Can offer an attractive alternative to a fixed income allocation.
5. Can be an effective diversifier within a balanced portfolio to potentially increase risk-adjusted returns, reduce portfolio volatility and help investors in an uncertain market environment.

DESCRIPTIONS OF INDICES

Barclays Capital US Aggregate Bond Index is the most common index used to track the performance of investment grade bonds in the US.

HFRI Merger Arbitrage Index tracks merger arbitrage strategies that employ an investment process primarily focused on opportunities in equity and equity-related instruments of companies which are currently engaged in a corporate transaction.

S&P 500 Index (Standard & Poor's 500 Index) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S.

DESCRIPTIONS OF TERMS

Correlation is a measure of how investments move in relation to one another.

Long is the buying of a security such as a stock, commodity or currency with the expectation that the asset will rise in value.

Market Neutral Fund is a fund that seeks a profit in upward or downward trending environments, typically through the use of paired long and short positions.

Maximum Drawdown describes a measure of risk (also known as Worst Historical Loss) that illustrates the largest peak-to-valley decline, based on monthly rates of return, during a given time period.

Risk-free rate of return is the theoretical rate of return of an investment with zero risk. It represents the interest an investor would expect from an absolutely risk-free investment over a specified period of time.

Sharpe Ratio is a measure for calculating risk-adjusted return and is the average return earned in excess of the risk-free rate per unit of volatility (or risk).

Standard Deviation is a statistical measure (single number) that sheds light on historical volatility. A volatile investment will have a higher standard deviation, while the more stable investment will have a lower standard deviation.

IMPORTANT RISK DISCLOSURE

Mutual funds involve risk including possible loss of principal. There is no assurance that the Fund will achieve its investment objective.

Investments in companies that are the subject of a publicly announced transaction carry the risk that the proposed or expected transaction may not be completed or may be completed on less favorable terms than originally expected, which may lower the Fund's performance. Investments in foreign securities involve greater volatility and political, economic and currency risks and difference in accounting methods. Investments in small and medium sized companies involve additional risks such as limited liquidity or greater volatility. Derivatives involve special risks including correlation, counterparty, liquidity, operational, accounting and tax risks. These risks, in certain cases, may be greater than the risks presented by more traditional investments. The Fund may make short sales of securities, which involves the risk that losses may exceed the original amount invested. The Fund may use leverage, which may exaggerate the effect of any increase or decrease in the value of portfolio securities or the Net Asset Value of the Fund, and money borrowed will be subject to interest costs. The Fund is non-diversified, meaning it may concentrate its assets in fewer individual holdings than a diversified fund. Therefore, the Fund is more exposed to individual stock volatility than a diversified fund.

Market Turbulence Resulting from COVID-19. The outbreak of COVID-19 has negatively affected the worldwide economy, individual countries, individual companies and the market in general. The future impact of COVID-19 is currently unknown, and it may exacerbate other risks that apply to the Fund.

Investors should carefully consider the investment objectives, risks, charges and expenses of AXS Merger Fund. This and other important information about the Fund is contained in the Prospectus, which can be obtained by calling 833.AXS.ALTS (833.297.2587). The Prospectus should be read carefully before investing.

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