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The Fixed Income Conundrum of Asset Allocators

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- With only 29% of the global bond market providing yields in excess of 1% [1], the low or even negative interest rate environment has become extremely challenging for Fixed Income and Multi-Asset investors.
- As yields are likely to stay lower for longer and investors can't count on further price appreciation, finding an alternative is an ever more urgent task.
- In this environment, Merger Arbitrage can provide investors with desperately needed positive carry without forcing them to increase credit, duration or equity risk.
- The strategy is an even more attractive diversifier if embedded in a multi-strategy framework including other uncorrelated strategies such as Credit Relative Value, Event Driven and Convertible Arbitrage.

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By fall next year, the great bond bull market will potentially be celebrating its 40th anniversary, with the US 10Y yield having fallen from a high at 15.84% in September 1981 to a low of only 0.51% in August 2020. Most Fixed Income markets in other developed countries have followed a similar path and a turning point is not in sight. Hence, asset allocators who have not given up on generating returns exceeding fees and inflation face tough choices. Those who do not want to bet the bank on equities should better look for alternatives.

1 Those who are said to be dead live longer

When the FED started hiking rates in 2015, Fixed Income and Multi-Asset investors were confronted with the scenario of a beautiful decades long bull-market finally coming to an end. Simultaneously, for the first time since the Great Financial Crisis, a rising rate environment provided some hope for higher reinvestment returns in the long-term and an end to post crisis financial repression. Unfortunately, the economic outlook in the US already became cloudy in 2019 and the Covid-19 crisis obviously put a harsh end to all dreams about a normalization of (real) interest rates in the medium-term. With rates near or below zero in most G10 currencies, Fixed Income and Multi-Asset investors alike are confronted with an increasingly dire outlook:

- Record high government and corporate debt levels in all developed nations indicate that rates are likely to stay lower for longer.
- Assuming that there is some kind of lower bound, windfalls from price appreciation are certainly a thing of the past.
- Given little upside but huge downside (for instance in case of a surprise jump in inflation) bonds' risk/return profile has become highly asymmetric.
- As rates can't move much lower, safe haven bond's diversification benefits are also more and more questionable.
- Yield curves are flat, leaving little room for roll-down gains.
- Credit spreads are tight, probably not reflecting the true default risk of increasingly levered corporations.

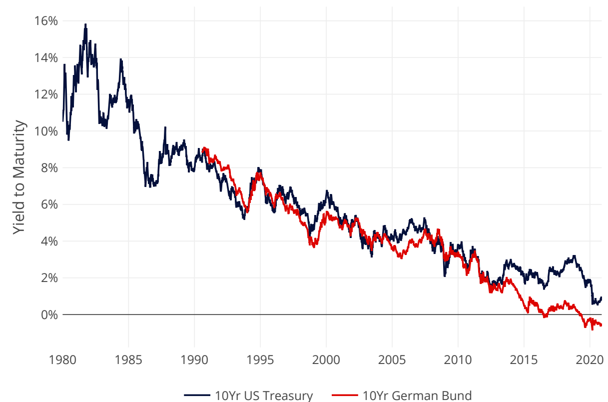

Figure 1: *Nothing left to squeeze*
Source: Bloomberg, Amadeus Capital

Multi-Asset investors have reacted to yield compression by shifting their allocations towards riskier assets including High Yield and Equities, resulting in significantly less diversified and more vulnerable portfolios. In short, classical Multi-Asset portfolios don't provide investors with the same risk/return profile as in the past. This fact has been concealed longer than expected by continued price appreciation in bonds but it may be time to look for alternatives now.

2 Time to think out of the box

Merger Arbitrage is a subset of Event-Driven investing and it has delivered favorable risk adjusted returns since the 90s. The strategy aims to benefit from uncertainty around M&A transactions. As there is always a small possibility that an announced deal will not be closed (deal break), the target company's stock typically trades below the acquisition price. Merger arbitrageurs seek to capture the difference between the market price and the acquisition price (merger spread) by buying the target stocks in case of a cash deal or by simultaneously buying the target and selling the acquirer in case of a stock deal. This provides the investor with a relatively predictable rate of return (as long as the deal does not break) over a pre-defined time-horizon (typically around 90 to 100 days). These characteristics make the strategy comparable to a short-duration Fixed Income investment. What nonetheless is highly interesting in the current market environment, it provides investors with exposure to a distinctively different risk factor: Deal break risk instead of credit risk and volatility features closer to bonds than equities. Deal breaks risk is the risk that a deal fails which ceteris paribus results in the shares of the acquisition target dropping to (and due to selling pressure from arbitrageurs in practice often temporary below) the pre-announcement level, resulting in losses for the arbitrageur. Statistical attempts to harvest merger spreads assume that over the cycle, losses resulting from deal-breaks will be overcompensated by gains from successful deals. On top of that, we believe that in this very specific niche market, an active strategy can create considerable value. Experienced merger arbitrageurs systematically review a number of factors to assess every deal's individual probability of success and thereby reduce the chance of getting involved in a deal break.

- Regulatory framework
- Financing of the deal
- Shareholders' risk tolerance

But also a wide range of details in the contracts that govern the acquisition. These contracts are specific to each transaction and hard to break or modify. As a result, the situations in a portfolio are essentially independent from each-other resulting in true diversification. In any case an investment is only pursued whenever the probability-adjusted risk/return profile is favorable. Last but not least an active manager monitors all deals on an ongoing basis and adjust the risk/return assessment and based on this the sizing of positions whenever new relevant information is received.

3 The past years - a dry spell

Of course, the strategy has not been unaffected by the board decline in interest rates. Deal spreads can effectively be divided into two components:

- An interest component, compensating the arbitrageur for the time value of holding the asset until deal close
- A risk component, compensating the arbitrageur for the risk that the deal breaks

Consequently, as interest rates decreased or turned negative, deal spreads have tightened respectively. At the same time, as outlined before, the strategy effectively has a very short duration and therefore benefits less from further decreases in rates than longer duration assets. Furthermore, just like in credit and equity markets the sometimes desperate hunt for yield of many investors resulted in an increasingly crowded space. As the number of deals depends on M&A activity rather than demand by investors, a rush into the strategy can impact its risk return profile negatively. Nevertheless, as an Arabic proverb states: "What is coming is better than what is gone". In spite of the quoted headwinds, the strategy has actually held up well over the past years and going forward, we think that the Merger Arbitrage glass is half-full rather than half-empty ... compared to a dust-dry Fixed Income glass.

4 2020 - probably a turning point

As the end of 2020 is coming closer, we can step back and ask what the year has brought for merger arbitrageurs. In this context the first impression is likely to be misleading. Certainly, 2020 has resulted in unprecedented drawdowns for Merger Arbitrage strategies as an equally unprecedented level of financial distress in March resulted in a drying-up of liquidity and rapid spread widening. Two major factors most likely impacted the space negatively during the crisis:

- Highly levered players were forced to quickly delever, resulting in fire-sales.
- More fundamentals oriented market participants dumped Covid-19 impacted sectors sometimes without accounting for special situations.

Nonetheless, despite record uncertainty, the number of deal breaks turned out to be well contained and was certainly far below what was priced in by spreads in March. To illustrate this more clearly: March spread levels implied that half of of the deals in our merger

arbitrage universe would fail. Nevertheless as of Mid-November 2020, only 4 out of 206 transactions that made it into the portfolio of the Merger Arbitrage fund managed by our sister company W Capital (see section 6 for more information) at some point failed outright (1.94%) and 5 (2.43%) were renegotiated.

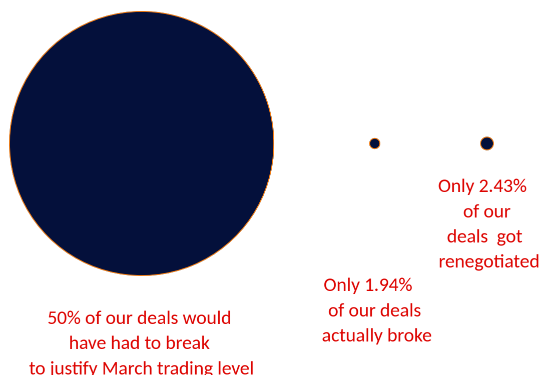

Figure 2: *A vast exaggeration*
Source: W Capital - calculations based on holdings of the W Decalia Abitrage Fund

The spread widening that resulted in major mark-to-market losses for the strategy was the result of short-term market inefficiencies and consequently got reverse over the following months (mechanical mean-reversion). At the same time, the contracts that govern the transactions have actually been further improved as a reaction to the crisis, making deals even harder to break today than before the crisis. While 2020 drawdowns statistically leaves the strategy looking riskier today, the opposite is true fundamentally: Embedded risks have decreased. At the same time, the elevated distress in March pushed many investors out of the strategy and let to a closure of several funds. For this reason the space looks much less crowded than it used to, resulting in more favorable spreads. It has clearly been shown that in order to live to fight the next battle it is crucial to have the right risk and leverage management that prevents being closed out of positions at the worst moment.

5 LVMH-TIF an epic example of the difficulty to renegotiate a deal

For Bernard Arnault the New York jeweler will probably be associated with a heavy hangover rather than a light breakfast. For merger arbitrageurs it unexpectedly became a Texas style rodeo but eventually ended with a reassuring note: Even a tough and relentless negotiator with excellent connections like Mr. Arnault can't pull out of a deal that easily. When it was announced, the takeover of Tiffany by French conglomerate LVMH was considered a perfectly safe deal. There were no real antitrust issues, the acquirer offered a decent premium and the target has been in business for more than 180 years and boasts a strong business and one of the most valuable brands in the world. Last but not least LVMH is a very solid and usually highly motivated serial acquirer. In short: This deal seemed as spotless as the famous Tiffany diamonds. Yet these strengths would soon become liabilities. When Covid-19 impacted the luxury retail sector through forced store closures as well as unprecedented travel and tourism restrictions, worries about the company's fair value combined with overly large exposure of merger arbitrageurs to the transaction created a perfect storm. As funds in need of liquidity dumped their positions, the spread widened from less than 1 USD to almost 25 USD. When equity markets calmed down after the initial crash and adverse liquidity pressures abated, the stock recovered quickly even though spread levels stayed elevated

However, sensing a bargain, LVMH in June initiated an aggressive campaign to weaken Tiffany's negotiating position, claiming its target had become subject to a Company Material Adverse Effect and it was soon leaked to the media that it's board seeked to abandon the deal. Predictably, the spread widened again tremendously for a short period of time. However investors realized that there needs to be a disproportionate and durationally significant impact on the company to justify a deal break based on the Material Adverse Change (MAC) clause. A couple of quarters of subdued operating performance, essentially in line with the industry, therefore hardly justifies a deal termination.

Figure 3: *The Tiffany roller coaster*
Source: Bloomberg, Amadeus Capital

At the same time, Tiffany also communicated plainly that it preferred to settle the dispute in court over renegotiating the deal. Rumours as well as LVMH's official comments eventually indicated that the acquirer was aware of the weakness of its arguments and reluctant to press the issue. This again brought a temporary recovery of the spread. Nevertheless, to the surprise of many investors, in September they revealed a letter from the French Government "ordering" them (according to LVMH) to delay the transaction beyond the walk date and therefore allowing LVMH to abandon the deal.

Rather than bringing Tiffany to the negotiating table however, this led their immediate filing of a lawsuit, claiming a breach of the merger agreement, and asking for the court to force LVMH to fulfill its obligation under the Definitive Merger Agreement (DMA). Tiffany's upbeat business performance during the summer further weakened LVMH's contention of a MAC, while the (in)famous government letter remained highly uncertain ground for the acquirer to escape its obligation. Having a much stronger hand, but eager to avoid too much uncertainty and delays. Tiffany ultimately accepted a very small price reduction (2.2% after dividend) in exchange for certainty of closing. The case clearly demonstrates that despite LVMH's reputation, contacts and financial means it was not able to renege its commitment. A contract (or a written paper) in this fake news world still has a lot of value and serves as a reliable key indicator in the risk assessment of a deal.

6 How we approach Merger Arbitrage at Amadeus

Our sister company W Capital Management has been managing a merger arbitrage fund since 2010. The product has since served as a cornerstone and additional diversifier in our asset allocation.

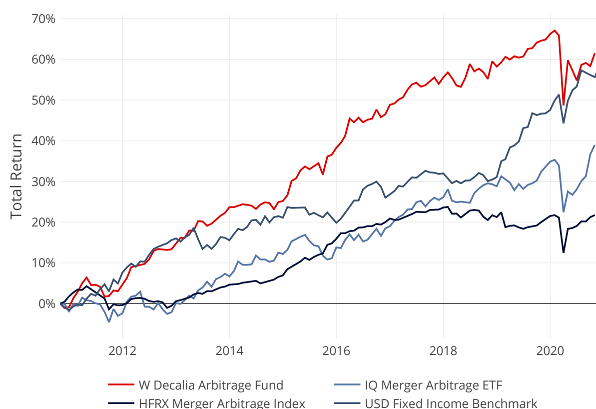

Figure 4: ***W Decalia Abitrage Fund:*** *USD share class proforma performance with 1.5% management fee and 20% performance fee (ISIN: LU1662741765)*
Fixed Income Benchmark: $1/3^{rd}$ *IShares USD Treasury 7-10Yr,* $1/3^{rd}$ *IShares 5-10Y Inv Grade Corp,* $1/3^{rd}$ *IShares 5-10Y Inv Grade Corp with monthly rebalancing*
Source: Bloomberg, Amadeus Capital, W Capital

As Figure 4 and 5 show, it has held up well against a Fixed Income benchmark with comparable volatility despite of the strong tailwinds the latter enjoyed. Most importantly, it also significantly outperformed the space as represented by the HFRX Merger Arbitrage Index as well as the only passive Merger Arbitrage strategy that has been in the market since 2010. In this context it is important to mention that the latter takes on basis risk as it shorts the sector instead of the acquirer in case of stock deals. This significantly decreases its correlation with our pure play strategy.

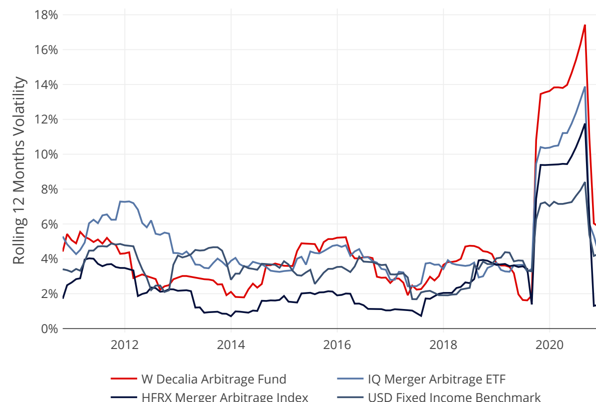

Figure 5: *Historically well controlled risk*
Source: Bloomberg, Amadeus Capital, W Capital

7 The best is yet to come

Even though the crisis in March brought unprecedented volatility and dislocations in the space, arbitrageurs managed to navigate the year without major casualties. Mark-to-market concerns remain paramount in the short-run but the strategy's long-term fundamentals are intact and most likely better than before the crisis. While March dislocations showed the previously hidden liquidity induced mark-to-market tail risk embedded in the strategy, just like previous market meltdowns, it also led to a further strengthening of merger contracts. Clauses are more specific today and cover a wider range of potential adverse events, reducing the true risk of the strategy. Beyond that we expect to finally see more generous spreads at least for some time grace to negative fund flows resulting in a less crowded market. Thanks to the crisis, fund managers have also improved their risk management, reducing the risk of another deleverage cycle such as in March 2020. Thus said, there is no golden rule to resolve the Fixed Income conundrum. Save government bonds with negative correlation to equities remain an important building block in Multi-Asset portfolios but now demand a fee just like any other insurance product. Significantly increasing credit and equity risk remains a dangerous game we would rather avoid. The medium-term impact of the crisis on the Multi-Asset world remains to be seen but in the current situation we think that Merger Arbitrage is an attractive addition to Fixed Income or Multi-Asset portfolios. If investors consider the scope of the strategy to be too narrow, diversification into other arbitrage strategies can complement this approach, thus allowing different uncorrelated strategies to play out their strength in tandem.

References

[1] Oleg Melentyev Anne Milne Martin Barnaby Hans Mikkelsen. “Global Credit Strategy Year Ahead”. In: *BofA Research* (2020).