Water Island Capital

The ArbCast – Episode #13: A Potential Fixed Income Solution in a Rising Rate Environment

Jenifer Bloodsworth: Welcome to ArbCast, Water Island Capital's podcast series where we strive to provide investors with concise and timely insights into the world of event-driven investing. I'm your host, Jenifer Bloodsworth, and joining us today is Gregg Loprete, Portfolio Manager of the Water Island Credit Opportunities Fund, ticker ACFIX, to talk about credit opportunities when bonds are getting you down. Gregg, thanks so much for joining us today.

Gregg Loprete: Hi Jen, happy to be here.

Jenifer Bloodsworth: Before we jump into the episode, I just want to say a quick congratulations as we sit here on March 12th, 2021, and it looks like your one-year performance is 7.42%. So far for the year, fixed income has had a really rough start, but your performance has been positive. Congratulations.

Gregg Loprete: Thanks. I think it's really just a reflection of the focus that we've had and all the refinements over the last couple of years with our selection and with our hedging. We're off to a good start.

Jenifer Bloodsworth: That's great to hear. Something that we are hearing a lot from investors right now is, "I just don't know what to do with my fixed income allocation." Interest rates and inflation seem to be a big topic of conversation as well. Could you share some of your thoughts on those areas?

Gregg Loprete: Yes, definitely. It is a unique time, certainly driven by COVID over the last 12 months. Fortunately, we do have an emergent economy; earnings seem to be increasing; employment's going in the right direction; we have stimulus on the way with fiscal policies and packages that were passed this week; and we have a dovish fed. Sadly, we have unemployment and underemployment rates that are still high. The U5, which is an underemployment rate - so it includes unemployment and people who are looking for work or have marginal part-time employment - had spiked up to about 16% a year ago with COVID and it's come down to 7% which is great progress. But pre-COVID, it was at 4%, so we do have some room to run there, but I think everything is going in the right direction.

I think the big thing is everybody's talking about equities having rebounded to pre-COVID levels, and interest rates have recently retraced up to about 1.6% to where they were prior to COVID. But keep in mind, at the end of 2019 rates were at 2%, and I looked back and at the end of 2018 rates were 3%. I think the concern in the market is, are we going back to those levels? That really sets the tone for the market, and then as you talked about, we have some challenges with investing in fixed income.

Jenifer Bloodsworth: Those are some great historical benchmarks to bear in mind. Are there other risks present in the market that you see right now and what are driving those risks?

Gregg Loprete: I think the biggest risk is what I mentioned before - inflation is really the big risk that people are talking about. I do focus on the bond side and I'd have to say that interest rates, where they currently are versus where they could be at year end, is probably scaring a lot of people. One of the things that we look at, and bond investors generally will look at, are inflation rates. Some of that has been provided by the Federal Reserve. For decades they've been providing it. Coming out of the financial crisis, they were guiding to a 2% inflation rate. The fear then was deflation. If you look at inflation expectations in the market, those were hovering between 1.5% and 2% for the better part of the last three or four years. And what's interesting now is if you look at those inflation rates and given some of the things that the Fed is talking about, those are still now pushing up to around 2.5% to 2.6% versus that 1.5% to 2% I talked about earlier. So I think the inflation brought about by stimulus and earnings and people getting back to work is really driving that fear in the market.

Jenifer Bloodsworth: Sure, but investors still need yield, right? So where can investors turn considering the risks that are present in today's market?

Gregg Loprete: Traditionally, when you have a fear of rising rates, investors tend to shorten duration. That's really the first thing. They'll go into floating rate bonds and loans. They'll purchase TIPS, for example. Some will also reach for more yield where there's spread. So we've seen that in high yield bonds this year that have performed pretty well. The lower down in credit quality you go, the less interest rate sensitivity that you have, but obviously there's danger in reaching for that. So that market is really less sensitive to interest rates than investment grade or the Barclays Agg.

Now what we do here with the Water Island Credit Opportunities Fund is another potential solution for investing in this type of market where people fear rising rates. What we do is we focus on corporate bonds, really the corporate high yield, corporate investment grade, and convertibles. What we do is we seek out investments whose returns are predicated on the timelines and outcomes of specific catalyst rather than a market direction. So, if we do our job well, then we can still offer yield and return with a very low correlation to rates.

Jenifer Bloodsworth: Great. So given those factors that we just talked about, could you explain to us a little more about your fund and how you think about investing?

Gregg Loprete: Sure. At the start of this year, when bonds were below 1%, I really felt that it was best to stay in some of the harder catalysts like mergers and acquisitions and refinancings, because I didn't want to be caught in a Taper Tantrum-like selling if rates were to move up rapidly. So I've basically been conservative and just waited for I'd call juicy catalysts. Really, what we do here is we're investing in specific catalysts. If I take you through an example, the best place to start is when you think about merger arbitrage. For those people who know merger arbitrage, or for those who don't, just think about a short-dated bond with near term maturity. What we do is we invest in situations that are triggered by these catalysts like a short-term maturity or a deal where a bond may have to be refinanced well before the intended maturity date. As long as those merger deals are completed, or the company meets its maturity payment or its redemption, then the investor essentially gets back their principal; we get back our investment and then we can deploy it into new deals. The portfolio, in a general sense, is idiosyncratic versus the market, and it exhibits low correlation. That's really how we approach things and how we're able to be cycle agnostic and rates agnostic.

Jenifer Bloodsworth: So investors can really think of your fund as a non-correlated solution for all market environments, is that what you're saying?

Gregg Loprete: Yes, I think that's a good way to look at it. The way we look at it, as I mentioned before, is we look at different catalysts, and it really depends on the market cycle. There are some cycles that you see a lot of mergers and acquisitions. There are other cycles where you'll see a lot of refinancings. In other cycles where maybe there's more distress out there, you might see some debt for equity exchanges and things like that. What I like about what we do is that there's always interesting things to look at. It just really depends on what the market is giving you at that time.

Jenifer Bloodsworth: Great. I know you mentioned the Taper Tantrum, but are there any other examples that you could walk us through and how you are able to generate returns in different environments?

Gregg Loprete: Sure. We do often talk about the Taper Tantrum just because it is probably the big event in the last 10 years where rates suddenly went up. I think that was the big fear of this year that we'd have that type of environment. During the Taper Tantrum, we were actually positive during that quarter, and the reason for it was we just had these transactions that I talked about in merger deals that were closing and other things that were closing, so we got paid on our investments. They moved up in a quarter when a lot of people who were tied to the market really had to suffer some shorter-term losses there.

But then we've had other situations, probably the best recent example is going back to a year ago when COVID hit. That was an incredibly stressful time with the markets. You saw equities that were down probably 30% from their peak and high yield was down 20% from its peak. Even the Agg, which is generally a very, very high-quality type of index, that index at its peak was down anywhere from 2.5% - 3%. So not terrible, but there was a lot of selling that was going on. For our fund, we were down in the first quarter about 5% and that was really our biggest drawdown amidst all of that selling. But people are really coming to us for some insulation. So, if during periods like that we're comparing ourselves to high yield, and that index was down 15% to 20% from its peak, then I think we did a reasonably good job. But the key for that period was really holding the portfolio, making sure it was solid, and making sure our hedges were in place. And what we did during that period is we really dug in and we said, "Okay, let's make sure that the ship is staying afloat. Let's make sure that we're comfortable with all of our positions." We doubled down into reading the indentures and finding out where we might be at risk.

Once we got through that first process of just making sure that we were comfortable with what we were holding, then it was that next question of separating out the noise and trying to look through everything that was going on and saying, “Okay, this crisis will eventually come to an end, so what's going to happen at the tail end or at least when we start to get those - to use a 2008/2009 saying - green shoots.”

We started to invest in merger deals that people had just thrown out the window saying, "Oh, this deal's not going to close for some reason," when in fact it was just selling that was going on. There was no problem with the deal getting done or anything like that. We found a lot of opportunities there. When we came out of March, or out of the first quarter, we performed pretty strongly. As you know, we finished up last year north of 6.5%. I think it was probably a good reflection of how we invest and how we think about the markets.

Jenifer Bloodsworth: Great. So as we sit here today, what do you see as the opportunities in the space currently and in the near future?

Gregg Loprete: Well, the biggest thing that we're seeing this year is we're continuing with lot of mergers and acquisition activity. The bulk of what we're seeing on the credit side really has to do with energy. We've seen a lot of energy deals where some better capitalized, better credit-profile companies are acquiring companies that have lesser profiles. So, we've seen those as refinancing opportunities or upgrade opportunities. And then there are other refinancings that have occurred. This market has been wide open for those types of things. Some of those refi’s are triggered by asset sales.

I think the more interesting thing that's happening in this market, everybody's talking about SPACs. We're not involved in SPACs on the equity side, that's a totally different ball game. But when there's a SPAC deal that's announced, meaning when they've announced an acquisition and they're going to take a company public through the SPAC, we look for those situations where they're going to use that transaction to raise more capital and to refinance debt. Those are really good situations for us. We've seen more than a few of those this year.

Then another place that we've seen is the IPO market. We've gone through 10 to 15+ years of very few IPOs. The number of companies listed has declined. Now this year we're seeing a lot of new IPOs. I'm not even talking about the SPAC type of IPO's, but other IPOs that private equity maybe is bringing to market. There are a couple of examples that we've been investing in there where the IPO proceeds will be used to refinance debt and the companies will raise more capital.

So that's really what I'm seeing right now in the market, and that really allows us to be steady and to be conservative.

Jenifer Bloodsworth: Great. Thank you, Gregg. Well, is there anything else that either you're thinking about with the markets today, or you think investors should be thinking about?

Gregg Loprete: I'm still in a place where I want to be conservative. I think the market is still trying to figure out this rates game, and there's definitely a tension between where equities are going and where bonds are going right now. I try to think about can we get up to that 2.5% on the 10 year or 3% on the 10 year? I think it's realistic to assume that. I still don't think some of the things in fixed-income-land offer a lot of attractiveness. Just using the Barclays Agg for an example, I just looked at it this morning and the yield on that - and this is really representing longer duration, higher quality assets - but the yield to worst on that is about 1.5% and the duration is still about 6.25 years. So, I don't know that you're being compensated for that. I think investors should probably be thinking along the lines of shorter duration or something that is kind of immune to these types of rates. I keep that as my backdrop. So, I don't want to get too aggressive, and I want to make sure that I'm hedged on anything with treasuries that might be longer duration. That's really how I'm approaching it. So, I'll continue to do that until I see reason to do otherwise.

Jenifer Bloodsworth: Gregg, thank you so much for your time today.

Gregg Loprete: My pleasure. It’s great being here, Jen, and thanks for having me.

Jenifer Bloodsworth: We've been speaking with Gregg Loprete, Portfolio Manager of the Water Island Credit Opportunities Fund, ticker ACFIX.

For those listening who may not be familiar with Water Island Capital, we are an asset management firm with a proven 20-year track record in event-driven strategies across public mutual funds, private investment vehicles, and our recently launched ETF, allowing clients to choose the best format for their exposure.

For more information on our funds, please visit our website arbitragefunds.com or call our resource desk at (800) 560-8210.

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As of March 12, 2021.

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ACFIX has limited availability and may not be accessible to all investors. The fund is also available in other share classes. Please see the fund’s prospectus for more details.

Performance through 12/31/20: ACFIX (I class), 6.71% (one year), 4.10% (five year), 3.18% (since inception 10/1/12); Bloomberg Barclays U.S. Aggregate Total Return Index, 7.51% (one year), 4.44% (five year), 3.84% (ten year); ICE Bank of America Merrill Lynch U.S. High Yield Index, 6.17% (one year), 8.43% (five year), 6.62% (ten year). Performance greater than one year is annualized. The performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be higher or lower than the performance quoted. For performance data current to the most recent month end, please call (800) 295-4485. Returns shown above include the reinvestment of all dividends and capital gains. Total Annual Fund Operating Expense for ACFIX is 1.72%. The Fund has entered into an Expense Waiver and Reimbursement Agreement whereby the adviser has contractually agreed to limit the total annual operating expenses of the Fund so that they do not exceed 0.98% for Class I shares, not including dividends and interest on short positions, acquired fund fees, costs incurred in connection with the purchase or sale of portfolio securities, and other extraordinary expenses. The agreement remains in effect until September 30, 2021, unless terminated at an earlier time by the Board of Trustees. Without such fee waivers, performance numbers would have been reduced.

RISKS: Investments are subject to risk, including possible loss of principal. There can be no assurance that the fund will achieve its investment objectives. The fund uses investment techniques and strategies with risks that are different from the risks ordinarily associated with credit investments. Such risks include event-driven risk; merger arbitrage risk (in that the proposed reorganizations in which the fund invests may be renegotiated or terminated, in which case the fund may realize losses); credit risk; convertible security risk; liquidity risk; market risk; sector risk; interest rate risk; short sale risk (in that the fund will suffer a loss if it sells a security short and the value of the security rises rather than falls); hedging transaction risk; large shareholder transaction risk; leverage risk; high portfolio turnover risk (which may increase the fund's brokerage costs, which would reduce performance); counterparty risk; swap risk; options risk; preferred security risk; investment company and ETF risk; derivatives risk; LIBOR rate risk; currency risk; foreign securities risk (in that the securities of foreign issuers may be less liquid and more volatile than securities of comparable US issuers, and may be subject to political uncertainty and currency fluctuations); active management risk; and temporary investment/cash management risk. Risks may increase volatility and may increase costs and lower performance.

Water Island Credit Opportunities Fund top ten holdings as of December 31, 2020: Capitol Investment Merger Sub 2 LLC 10% 8/1/2024; Cincinnati Bell Inc 7% 7/15/2024; Cincinnati Bell Inc 8% 10/15/2025; EIG Investors Corp 10.875% 2/1/2024; Pluralsight Inc 0.375% ; Refinitiv US Holdings Inc 6.25% 5/15/2026; Slack Technologies Inc 0.5% 4/15/2025; Stars Group Holdings BV 7% 7/15/2026; T-Mobile USA Inc 6% 3/1/2023; Verint Systems Inc 1.5% 6/1/2021. Top ten holdings represent 35.5% of the portfolio. Holdings are subject to change. Current and future holdings are subject to risk.