The ArbCast – Episode #15: AltShares Merger Arbitrage ETF's One-Year Anniversary

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 we have a very special episode today to mark the one-year anniversary of our AltShares Merger Arbitrage ETF, ticker ARB.

Launching our first ETF was certainly the work of many people, but joining us today are two individuals who were absolutely critical. Our first guest is Chris Plunkett, who is a Portfolio Manager ("PM") on the AltShares Merger Arbitrage ETF, and also currently serves as the firm's Director of Technology and Data Analytics, where he manages teams responsible for the firm's technology, infrastructure, development, and information security.

The second is another Portfolio Manager on the ETF, Eric Becker. In addition to being a PM on the ETF, Eric is a Senior Investment Research Analyst on the firm's actively managed merger arbitrage strategy. Guys, welcome to the podcast and congratulations on the ETF's one-year anniversary.

Eric Becker: Thank you very much, Jenifer.

Chris Plunkett: Hi, Jen. Thanks for having us.

Jenifer Bloodsworth: So Chris, why don't we start with you. Tell us what was your motivation for launching the ETF?

Chris Plunkett: Well, Water Island Capital has been actively managing merger arbitrage strategies for over 20 years now, and our team began working on our first merger arbitrage index roughly five years ago when we identified a gap in the marketplace. While there were a couple of existing merger arbitrage ETFs, we felt that none of them provided investors with exposure to a true, pure-play merger arbitrage strategy as we provide to our mutual fund clients in an active format. By this I mean a strategy that sets the spread on every merger transaction in the portfolio. When a deal involves a stock payment, the effective employment of the merger arbitrage strategy requires a short position in shares of the acquirer to lock in a deal spread and isolate the investment from external market volatility.

In addition, any effective merger arbitrage portfolio must be constructed with a sound risk management framework. We felt that these core components of the strategy were not being addressed so we decided to leverage our expertise in merger arbitrage investing to construct a rules-based ETF which would represent our investment philosophy.

We also recognize that there are some investors who simply prefer ETFs, maybe because they typically carry a lower cost or they can be more tax efficient than their mutual fund counterparts. Whatever the rationale, we want investors to be able to access our strategies in whatever fund wrapper works best for their portfolios. So, we want to be wrapper agnostic in that sense.

Jenifer Bloodsworth: Great. So Eric, I know that we launched this ETF in May of 2020. What was it like launching it during the pandemic?

Eric Becker: Jenifer, it was a very memorable launch for a number of reasons and the pandemic was certainly on that list. We had originally targeted a late March or early April launch, but given the chaos and volatility in the markets during that time, the feedback that we received from our lead market maker GTS and the New York Stock Exchange was to push back the launch. So we did, and we ultimately launched the fund in early May.

Now in regards to launching during a global pandemic like you mentioned, it certainly wasn't a part of the original plan. But the pandemic created an extremely volatile market and it was an environment that we had experienced at Water Island back in 2008/2009 during the Financial Crisis. And that time period really provided - for our firm and our funds at that time - some great opportunities for the merger arbitrage strategy. So, we were eager to push forward with the launch early in the second quarter and take advantage of some of the outsized opportunities and dislocations in merger arbitrage spreads that we were experiencing and seeing in May and June. Pushing forward with the launch did ultimately benefit the ETF’s performance in the early days.

So ultimately, we were pleased with the support we received from all of our service providers, whether it be State Street, or our lead market maker, or the New York Stock Exchange who made this a seamless and a successful launch.

Jenifer Bloodsworth: Great. So Chris, looking back over the past year, what part of the journey stands out?

Chris Plunkett: Well, since the firm's inception, Water Island Capital has only offered actively managed strategies. So, learning to how to take a step back with the passive fund was definitely challenging at times. With ARB being the first ETF and the first passively managed strategy Water Island has offered, we certainly learned an awful lot last year.

What probably stands out the most is the creation and management of the underlying index that ARB tracks. You know, once you remove all the emotions, managing a passive ETF is relatively simple. But the index is where the strategy really takes shape. And as a self-indexed fund, we have oversight and management responsibilities for the index in addition to the ETF.

We developed this index internally for a few years. We took all of the knowledge that our investment team has gained from actively managing merger arbitrage strategies, and we distilled that knowledge into our rules-based strategy.

There are a handful of core principles or tenants of merger arbitrage investing that our team believes in and follows, and we focused on embedding these into the rules-based strategy. We ran internal paper portfolios tracking the index for a year or two to monitor deal selection, weighting, and performance of the strategy in real time. During this time, we tested, tweaked, and improved the rules numerous times over, and we applied the rule set historically through back tests. We really took our time to make sure we got the strategy right, and as a result, we believe that the ARB ETF is truly one of a kind and offers investors broad exposure to a merger arbitrage strategy that was developed by actual merger arbitrage experts.

Jenifer Bloodsworth: Terrific. Well, that's a great segue. Why don't we dive into the strategy a bit more. Eric, tell me, what do you feel differentiates our merger arbitrage ETF?

Eric Becker: Yeah, I really feel there's two factors that stick out to me when I think about what differentiates this ETF and what makes ARB unique.

I'll start with our main focus when we were developing the methodology. Chris alluded to this earlier, but it was to employ a pure-play approach to merger arbitrage. We want it to solely focus on capturing spreads and eliminate market exposure, and to provide our clients with a broad exposure to the merger arbitrage strategy with the goal of providing positive non-correlated returns.

What I'm specifically referring to when I refer to pure-play merger arbitrage is hedging out or shorting the acquire on stock-for-stock transactions, and also all the external factors like foreign exchange risk. So we felt when we started this process over five years ago - and we still feel - a true passive, pure-play merger arbitrage ETF did not exist. And it presented a real opportunity for us at Water Island.

The second point I'll make in regards to how ARB is differentiated is our rebalancing strategy. We rebalance this ETF twice monthly, and by rebalancing the portfolio on a more frequent basis, that allows us to reassess the risk-return profile of the deal universe and re-allocate capital to maximize exposure to the best opportunities more frequently than other ETFs who are rebalancing monthly or even quarterly. You know, our bi-weekly rebalance strategy, during the pandemic and the volatility, was extremely valuable. On a number of occasions, the ETF was able to buy extreme dislocations and really trade around negative spreads. So, that has really stuck out to us as a key differentiator over the past year.

And lastly, I think it's extremely important to point out again that our 20 years of experience of managing merger arbitrage portfolios is really at the core of this ETF. And it's very apparent when you dig into the index's methodology that our strict risk management processes have been implemented.

Now, I'll just provide one example. We have developed a formula to risk-adjust position weights that are based on potential losses for each individual deal in the portfolio. So without getting too far into the weeds, that means that the index is calculating a downside for each individual position in the portfolio. And what that allows us to do is to cap position sizes based on the potential losses for each individual deal. That's opposed to solely focusing on liquidity to size position or simply equally weighting each deal in the portfolio. And that's a clear differentiator for us, and we've been able to see the benefits of that unique rule during our first year of operation as well.

Jenifer Bloodsworth: That's terrific. Chris, do you have anything to add on what you've seen as far as the benefits of this approach and how it's manifested itself over the past year?

Chris Plunkett: Oh sure. Our primary goal is to offer investors exposure to a merger arbitrage strategy that has low volatility and low correlation to the broader equity and credit markets.

The fund’s returns over the past year have certainly met or even exceeded our expectations, but more importantly, the fund exhibits exceptionally low beta to broader markets and very strong Sharpe and Sortino ratios. I think this speaks directly to the fund's risk management and hedging rules, and it distinctly separates ARB from its peers.

Merger arbitrage can be a very effective portfolio diversifier, but without the proper hedging and risk management that Eric just talked about, the strategy can become overexposed to external market volatility. We believe that the strategy of the ARB ETF, derived from our investment team’s experience, addresses these issues effectively, and it offers investors low-cost exposure to a pure-play merger arbitrage strategy.

Jenifer Bloodsworth: Great. Well Eric, what can you tell us about what's driving the merger arbitrage opportunity set today and where do you see things in the near future?

Eric Becker: Sure, Jenifer. The opportunity set is robust and we continue to see a surge in mergers and acquisitions (“M&A”) announcements. We really started to see a flurry of deals, and that started in the fourth quarter of 2020 last year. That momentum has continued into 2021, and it's been across various sectors. It's been information technology, semiconductors, the energy sector, financials, and even healthcare. They've all been sectors that have experienced consolidation over the past several months.

And that relatively quick snap back in deal flow was not all that surprising to us. You know, at Water Island we've experienced and successfully navigated several periods of market stress, and what we've learned from the past - like the Financial Crisis in 2008 - is that the substantial declines in the M&A market, which we experienced in the second and third quarter of last year, lead to sharp recoveries. And we continue to hear from investment bankers and management teams on the quarterly calls that are taking place, that there's still pent-up demand for M&A. So deal flow remains a nice tailwind for the fund.

What we're also excited about is the competitive bidding situations that have acted as a tailwind for the ETF’s performance as well. And the competitive bidding and increases in deal considerations have been the result of the improving economic conditions globally, as we continue to recover from the pandemic. But more importantly, the underlying fundamentals of the target companies continue to improve, and what that has done is it's resulted in higher bids because shareholders have been pushing back on the original deal terms that were agreed upon. So, acquiring companies have not been able to secure the shareholder votes that are required to close these deals, and they've been forced to pay a higher price to get them done.

We've also been invested in deals where competitors have identified an opportunistic bid by a competitor and are willing to pay a higher price. We've been invested in a couple of bidding wars that have resulted in nice outcomes for us this year.

So, it's really been a combination of deal flow and overbids that have us excited and really proud of our performance year-to-date and over the past year. And it has us optimistic about the months and really the year ahead.

Jenifer Bloodsworth: Yeah, it seems like it's such an exciting time in the space right now. Chris, what are the plans for AltShares moving forward? Is there anything that listeners can look forward to on the horizon?

Chris Plunkett: Sure, Jen. You know, while AltShares is still relatively new in the ETF space, we plan to be here for the long haul. We are dedicated to growing our suite of ETFs and offering more of our event-driven strategies to investors in ETF formats.

We are very excited to share that we plan to launch our second ETF later this year. We've submitted the initial filings with the SEC to begin this process, so please keep your eye out and stay tuned.

Jenifer Bloodsworth: All right, sounds good Chris. Well guys, thanks so much for joining us today.

Chris Plunkett: Jen, thank you very much for having us. It was great.

Eric Becker: Thank you, Jenifer.

Jenifer Bloodsworth: Again, we've been speaking with Chris Plunkett and Eric Becker, Portfolio Managers on our AltShares Merger Arbitrage ETF, ticker ARB .

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 - as of one year ago - ETFs, allowing our clients to choose the best format for their exposure. For more information on our ETF, please visit altshares.com, and for more information on our 40-act mutual funds, please visit arbitragefunds.com. Or you can always call our resource desk at (800) 560-8210.

Thank you so much for joining us today.

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