Water Island Capital

The ArbCast – Episode #16: 2022 Outlook – Headwinds for Core Bonds and a Fixed Income Alternative to Consider

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 fixed income investing in 2022 and the opportunities in event driven credit.

Gregg, thanks so much for joining us today.

Gregg Loprete: Thanks, Jen. Good to see you.

Jenifer Bloodsworth: Thanks. So Gregg, before we talk about expectations for the fixed income markets in 2022, perhaps it would be helpful to briefly take a look back at 2021 and discuss how we got here. It's been a difficult year for traditional fixed income, highlighted by the Bloomberg US Aggregate Bond Index's ("Agg") year-to-date performance of negative 1.65% as of 12/15/2021.

Meanwhile, the Water Island Credit Opportunities Fund, which has historically had a similar risk-reward profile to traditional fixed income, has returned roughly 3% over the same time period. The last year the Agg struggled this much was back in 2013 when it was down 2%. Meanwhile, Gregg, your fund was up around 5.2%.

Can you touch on some of the things that negatively impacted the fixed income markets and how you were able to navigate them so well?

Gregg Loprete: Yeah, sure. Happy to do so. I think we all remember coming out of 2020; we were really getting to the tail end of the pandemic; the Federal Reserve and central banks had come in to really support financial markets; federal governments had stepped in; people were starting to get back to work. So, people started to talk about inflation again and reflation and so forth. And so, 2021 really started with rates that were - and I'm using the U.S. government ten-year - less than 1%. And during the first quarter, they quickly gapped up to about 1.7%. Five-year rates at that time were 45 basis points at year-end, and currently they're about 1.2%. So, obviously rates going up in the first quarter worried a lot of investors, but since then rates have really moved back down and stabilized somewhat. But the dialogue hasn't changed at all, and it's constantly about inflation and supply chain issues. But rates really have not moved a lot. I have some thoughts about why that might be, but to get us where we are now, particularly with longer duration aggregate bond types of investments, it was really because rates had gone up and that negatively impacted that market.

For us, what we do is invest in a strategy that's somewhat immune to the movement in interest rates. And so, when you look at what we do in the Water Island Credit Opportunities Fund and the key distinctions between traditional fixed income and what we do, it's pretty basic in a sense. And one is that aggregate bond, traditional fixed income, it's really long duration, and what we do is traditionally short duration. Our investments are short duration, the aggregate bond types tend to be long duration. And then the second thing is a lot of the fixed income funds out there are really long-only. So, they're long yield, long duration. In our portfolio, we run it as a long-short portfolio.

And so, big picture wise, our aim is really to deliver positive returns regardless of the direction of rates. Specifically, and this goes into a little detail of the fund, we're what's called a catalyst-driven or an event-driven focused fund. What this means is that we're investing in the corporate credit markets. So, it's high yield, it's investment grades, convertible bonds, and bank loans. But we're really seeking situations that arise from those specific markets. And what we do is we try to generate those returns based on the timelines and the outcomes of those specific, idiosyncratic events.

I'll leave it there, but that's really where we've come from this year. Inflation is still very much on people's minds, and what we do is somewhat unique and it's allowed us to really navigate through this market with positive returns.

Jenifer Bloodsworth: Great, thanks for that. So, Gregg, you mentioned inflation, duration, rates - what are your expectations for these things in 2022, and how do you see them impacting the fixed income investment landscape.

Gregg Loprete: That's the question on everybody's minds right now. I think the one thing that I'll say bothers me - and I think earlier I'd mentioned that with fixed income there's probably an explanation for why rates are so low. One is because investors really think that the Fed has a handle on things. And that was really confirmed in this week's press conference with Jay Powell, the Fed chairman. And I think investors, particularly for the long term, are comfortable that they're going to be somewhat hawkish, somewhat dovish, but that there's a relative balance there. So I think that's one side of it.

The second side is to keep in mind fixed income is a global market. And yes, while the U.S. Treasury yields may be 1.4% to 1.5%, Germany still has negative yields, the UK has yields about a hundred basis points south of where we are, and in Japan yields are about five basis points. So there is that aspect of it.

But what really bothers me is I went back and I took a look at inflation expectations and inflation expectations relative to yields. And if you go back to pre-2008, you always had a positive correlation or a positive spread between the two. And what I mean here is that you always had to have a positive real-yield, and if you didn't have a positive real-yield that meant that investors were losing buying power, which one of the basic tenants of fixed income financing is that you want a yield that exceeds the inflation rate. And so back then, pre-2008, you really saw yields – real-yields - that were somewhere around 100 to 200 basis points. And since 2008, we've gone from 1% down to negative yields. And if you look at where we are now - and I'm using the five-year here - we basically have a difference between inflation expectations and five-year bond yields of negative 1.5%. So that means people are actually losing buying power in this market.

In my view, at some point that has to change. I don't know when it's going to happen, I don't know how it's going to happen, but it's got to revert at some point. The last time we were this negative was actually heading into the Taper Tantrum in 2013. So, to me, it seems like we're as negative as we've been in the past 10 or 20 years and it feels like it's going to revert at some point.

So, looking at those risks, I'm always looking to be opportunistic in the market. We set up the portfolio so that in those scenarios where we do have big sell-offs, we can stay well invested, we're hedged well, our investments are short duration, and they tend to be less impacted by a lot of longer duration stuff. So we use those types of markets where there are selloffs really to invest in specific opportunities where you've had spread widening and price correction and so forth. So, looking forward, I will continue - like I did this year - to wait for those opportunities and be invested in what I see as relative safety until then.

Jenifer Bloodsworth: Great, thanks. Gregg, what other key risks should investors consider for 2022, and are there any other risks you're considering that may not be widely talked about?

Gregg Loprete: Good question. Well, when you think about the markets that we're invested in, or I should say the types of catalysts, we tend to invest in things like companies impacted by mergers, acquisitions, spin-offs, asset sales, and the like. I think one of the key risks that we see in those markets are really related to regulatory, trade tensions, even to an extent China and Russia versus the West. Right now, that's a big topic that I think everybody's watching.

But the merger arbitrage community specifically, they really ran into a lot of headwinds this year with regulatory and anti-trust, kind of this fear at the government level of large corporations and large technology corporations, and then definitely with trade tensions, particularly with China. A lot of the transactions that the merger arbitrage community looks at have to get approval by China or by the EU. And so in a lot of cases here, they faced deals that were either not approved or there was a lot of doubt about whether they'd be approved and that led to, in some cases, cancellation of some deals. So I think that's one risk that certainly has to be looked at in 2022. I think we'll continue with what we saw last year, but we'll be watching that closely. Also, we'll be looking for, like I said, any type of increased trade tensions. I think any meeting that occurs between the U.S. and China, if there's a positive outcome then that'll definitely have a positive impact on our markets as well.

Jenifer Bloodsworth: Gregg, the role of traditional fixed income has historically been to provide capital preservation, diversification, and liquidity to portfolios. Given some of the things we've discussed, it seems valid that investors are wary that they may not be able to expect those tenants from their core bond holdings moving forward. Could you spend a little time discussing why your strategy can be viewed as an alternative to traditional fixed income, and why you believe it can serve as a good compliment or replacement to that sleeve of an investor's portfolio, especially given some of the risks we've discussed?

Gregg Loprete: Sure. Let's take a step back and think about fixed income investors and why people invest in bonds and fixed income. Usually you're either seeking income, capital preservation, or really a combination of the two. The problem is that if you want both, then there are some risks. So, if you're looking for capital preservation then you really want to get into high quality types of investments. That really gets you into the bulk of the aggregate bond index. So, if you want capital preservation, you're going to get a pretty skinny yield of about 1.7% to 1.8% right now, but your risk there is 6.8 years of duration. So, if the ten-year or the seven-year moves up by a hundred basis points, then your investments are down 6% to 7% for that year, excluding your carry. So, if you don't want that type of interest rate risk, then a lot of people will move over to get yield, and that's going to drive you into the high yield market.

In the high yield market - in the U.S. high yield market - you could still get a 4% to 4.5% return there. But, of course, then you’re talking about concerns with not only the sensitivity to rates to a lesser degree, but also the credit quality. If you do get a soft market, if you get a sell-off or that sort of thing, then that type of strategy can really come under some pressure.

So, our strategy is really a hybrid approach. That is, we can deliver returns of the short-term high yield market with little sensitivity to rates and certainly much less sensitivity to high yield during market sell-offs.

And if you go back and you look at the two sides of that - if you look at the Taper Tantrum or other periods where fixed income and interest rate sensitive investments were really hurt - we perform pretty well. In most of those cases, if not all, we were positive during those quarters and during those years. And then if you look at periods where there's risk-off in the market, where equity markets are on fire, on fire in the sense of trading down, or you look at the high yield market when it's trading off, we have outperformed to a pretty large degree during those markets.

So, like I said, we're really a bit of a hybrid here where we're able to capture income, we're able to have stability of principal and capital preservation, and I think the strategy is unique in that sense.

Jenifer Bloodsworth: Thanks, Gregg. So it sounds like you're primarily investing in high yield, but the strategy has historically had a risk return profile very different than a typical high yield portfolio. Could you expand on that a little more and maybe walk us through an example.

Gregg Loprete: Sure. A good example over the past year - and what I had said earlier is that a lot of the portfolio we're looking to invest in merger and acquisition types of transactions. So a lot of people may be familiar with merger arbitrage from an equity standpoint. I'll use an example here that’s a stock example and a bond example.

So when I think about Michaels Stores, I think a lot of people are familiar with their arts and crafts stores that you see in a lot of strip malls and so forth. Their mail order business has obviously improved tremendously through COVID. In February of last year, Apollo Group - which is a private equity investor - launched a $22 cash offer for Michaels Stores. So prior to this deal, Michaels Stores was trading somewhere around 25% to 30% lower than that bid. So, in the event that the deal broke, equity investors could probably suffer 25% to 30% loss on their capital. But what they're looking for there is that the stock would trade up to say $21.75, and they're looking to capture that last 25 cents spread. And that's really what a merger arbitrageur or a risk arbitrageur looks to capture in that market. So there's a small amount of upside, but there can be a fair amount of downside.

What we do in the portfolio, looking at this Michaels Stores example, is we're very aware of what goes on on the equity side, but what we're looking at is does Michaels Stores have debt. Do they have any bonds outstanding? Do they have bank loans? And if so, what's going to happen to that part of the balance sheet from a takeover offer? And so, we immediately go in, we look at the bonds, we look at the covenants and the prospectuses and all the rules and restrictions underlying those bonds to find out what the path is for those bonds pending the deal being completed or not completed.

So in this case, we were able to identify two bonds in Michaels Stores capital structure, and we thought that through our research that Michaels Stores, or in this case Apollo, would need to redeem these bonds earlier than the maturity date in order to affect this merger, to get this merger to go through. The second part of this is that the spread that we were able to attain here was equal to, if not a little bit better than, what the equity-based arbitrage players saw. But the best part about it is if the deal broke, rather than seeing 25% to 30% downside, our bonds would have expected somewhere between 3% and 5% downside, so much better risk-reward.

So, to get back to your question about even though we're invested in the high yield market, how do we differ? Well, Michaels Stores was a high yield credit at that time. And the market earlier this year zigged and zagged, it went up and down. We didn't care about that. All we cared about was that Michaels Stores was going to have its bonds redeemed. That, to me, was going to be the trade. So we invested in the bonds and they were redeemed when the deal closed. I think that was in the summertime, and we were able to maintain that return.

Taking another look at that, let's assume that this same deal had occurred when COVID was launched. And we had a lot of deals that were pending when COVID had hit. Some of those traded off with the market, but as long as those deals were going through, meaning they were going to be completed, then those bonds and that stock would have to be redeemed for cash. So you have a quick snap back as long as those deals go through. So that's really how we differentiate.

Jenifer Bloodsworth: Thanks, Gregg. What would you say are the opportunities in your space currently, and what, if anything, are you excited about as potential opportunities in 2022? Would you consider there to be more tailwinds versus headwinds for your strategy or vice versa?

Gregg Loprete: I think I'm probably straight down the fairway as far as opportunities or threats. I mean, the threats we talked about, I think it's going to be coming probably from inflation and rates. We don't know when that might happen, if it happens. But on the other hand, I'm pretty optimistic about the types of opportunities that we see.

I think mergers, acquisitions, SPACs, IPOs – I think those types of opportunities are going to be plentiful. There's a lot of money at private equity floating around right now. SPACs have been pretty active investors. Companies are still looking to streamline their businesses through asset sales and acquisitions. So, I think that those are going to be good opportunities through the New Year. But the way that we run the portfolio, to me, if the market falters or we see a return to more sane valuations in the equity markets, then I really see opportunities in the convert market at that point.

So I think for most of the year the mergers, acquisitions, spin-offs, and asset sales, those are going to be the drivers of the bulk of our returns. But if we do get a sell off and we have an opportunity to buy converts or busted converts, I think that'll be another great opportunity, but time will tell.

Jenifer Bloodsworth: Great. Gregg, thanks so much for your time today. So, I'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 currently our recently launched ETFs, allowing clients to choose the best format for their exposure. For more information about our funds, please visit our website at arbitragefunds.com or call our resource desk at (800) 560-8210.

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As of December 16, 2021.

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Performance through 9/30/21: ACFIX (I class), 4.82% (one year), 3.71% (five year), 3.17% (since inception 10/1/12); Bloomberg US Aggregate Bond Index, -0.90% (one year), 2.94% (five year), 3.01% (ten year). 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 lower or higher than the performance quoted. For performance data current to the most recent month end, visit http://arbitragefunds.com or call (800) 295-4485. Returns shown above include the reinvestment of all dividends and capital gains. Returns greater than one year are annualized. Total Annual Fund Operating Expense for ACFIX is 1.52%. The adviser has contractually agreed to waive fees in excess of 0.98% for ACFIX until September 30, 2022, excluding the effects of taxes, interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses, and other costs incurred in connection with the purchase or sale of portfolio securities. Without such fee waivers, performance numbers would have been reduced.

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