Water Island Capital

The ArbCast – Episode #18: AltShares Merger Arbitrage ETF – Differentiated Returns in Difficult Markets

Jenifer: 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, Jennifer Bloodsworth, and joining me today is the team that spent years developing the AltShares Merger Arbitrage ETF, ticker ARB, starting with John Orrico, the founder and CIO of Water Island Capital.

John Orrico: Hi, Jen. Thanks for having me today.

Jenifer: Thanks John. Next, we have Portfolio Manager, Eric Becker.

Eric Becker: Hi, Jenifer. Thank you for having me.

Jenifer: And finally, we have Portfolio Manager, Chris Plunkett.

Chris Plunket: Hi, Jen. Thanks for having us today.

Jenifer: Thank you each for being here. So John, you started Water Island Capital almost 22 years ago, but your experience in merger arbitrage and event-driven investing goes well beyond that. Can you share with listeners some of the merits of the strategy and why it's been able to stand the test of time?

John Orrico: Great. So let me step back a minute, Jen, to answer that question. When we think about how investors should consider event-driven strategies within the context of their overall portfolios, these strategies - for instance, such as merger arbitrage - are designed to deliver consistent investment returns over an investment cycle. But what's most important is that these returns are not correlated to the overall equity or fixed income markets.

So, when we think about how institutional investors and high net worth investors have sought to diversify their portfolios utilizing event-driven strategies - whether that be moving away from fixed income during a rising rate environment or as a buffer to their equity portfolios when markets appear overvalued or are experiencing heightened volatility - in both cases, event-driven strategies such as merger arbitrage can provide a positive return stream but with much lower levels of volatility compared to the overall markets.

And then finally, let me mention that the merger arbitrage strategy, which is what we're talking about today through the ARB ETF that we launched, if designed and implemented properly, can serve as a tool to preserve capital for investors as well.

Jenifer: Great, thank you. So John, after managing active mutual funds and private products since the firm's inception, you launched the AltShares Merger Arbitrage ETF in 2020. This was your first passive strategy and first ETF. Can you walk us through the genesis of that decision?

John Orrico: Sure. This process goes way back, and as we examined the ETF landscape over the past decade, or even further back, what we saw was a gap. To even take us back to a period much earlier, over two decades ago when we looked at the mutual fund landscape, what I recognized back then was the lack of non-correlated or hedged strategies that were available to investors in 40-Act mutual funds.

So here we were over the past decade looking at the ETF landscape, (and it’s the) same thing; a lack of non-correlated strategies, capital preservation strategies, strategies that offer investors a hedged investment strategy that can protect their portfolios in volatile or down markets, but also offer upside return potential as well. As we examined that landscape, we took a hard look at some of the ETFs that were already in existence that advertised themselves as hedged or non-correlated strategies. And even a few of the ETFs that claim to focus on the merger arbitrage strategy, we found to be lacking in terms of their ability to deliver the attributes of these strategies as advertised. So, what we discovered was that the vehicles that were currently available to investors in the ETF community were poor proxies for the strategies that they claim to offer to investors. And therefore, the intended benefits of that non-correlation and capital preservation were not coming through to investors.

So when we think about the fundamental principles around a strategy like merger arbitrage, we focus on diversification and hedging risks through a rigorous application of downside protection and risk mitigation, and all of that is accomplished through diversification, value-at-risk analysis, and hedging. So after what was many years of development by our team, we launched our first rules-based ETF, which incorporates most, if not all of the principles that we embrace in our actively managed funds today.

So, we're really excited about the ETF. We're really excited about the benefits we think it will bring investors that are looking for these types of strategies in their ETF portfolios. What we're offering in the marketplace today is an effective, low-cost event-driven fund that maintains our goals as a firm to protect investor capital by offering them a differentiated or non-correlated return stream.

Jenifer: Thank you. Eric, I'd like to turn over to you now. You've been working with the merger arbitrage team for many years. How would you characterize today's market environment for the strategy?

Eric Becker: Yeah, thanks, Jenifer. You know, when thinking about the current merger arbitrage environment, I think it's important to understand historically what the return opportunity has been for the strategy in a normal market environment. Merger arbitrage spreads, or the return opportunity, has returned 3% to 4% above cash or the risk-free rate over a full market cycle. But with the recent market volatility and the record setting deal flow, it's really created an unprecedented opportunity for the strategy.

And I would be remiss not to first elaborate on the record-breaking pace of mergers and acquisitions (M&A) that we've been witnessing and is one of the key drivers for why the environment is attractive today. Now of course mergers are always happening during all phases of the market cycle, but it has been a remarkably broad-based boom in deal flow recently, and it's provided us with the ability to spread the strategy’s dollars across a broader opportunity set. And that's both in the U.S. and internationally. So deal flow has certainly been a nice tailwind for the strategy.

And I mentioned volatility. As John pointed out, the strategy is time tested. We've been managing this strategy for 20+ years successfully, and our experience in navigating periods of extreme volatility like the Financial Crisis of 2008 or more recently the COVID-19 pandemic, you know, those periods really tended to be very prosperous times for the strategy. And that's really due to the fact that returns are closely tied to the outcomes of specific short-term events, rather than the overall market direction. And just to further clarify that point, once a transaction or a definitive merger is announced, the shares of the target company tend not to trade in line with the direction of stock or bond markets, but rather based on the progress of the deal. So market volatility or periods of market stress like we have been experiencing have created attractive entry points and return opportunities in the deals in which we invest in globally.

So, deal flow and volatility, those are both factors that have been positively influencing merger spreads. And another component of the deal spread or the profit opportunity that John also alluded to, and has been dominating headlines recently, is interest rates. Historically, interest rate hikes have acted as a nice tailwind for the strategy, which is why one of the strategy’s most common uses is as a portfolio diversifier, particularly as a fixed income alternative.

And I think it's best to describe this by using an example. So, the structure of a merger arbitrage trade is actually very similar to a zero-coupon bond, which is purchased at a discount and pays its face value upon maturity. And very similarly, as merger arbitrage investors, we are purchasing a target company at a discount to the deal value and then receiving that deal value upon the completion of the merger. Unlike bonds, however, rates of return in the merger arbitrage strategy have historically benefited from rising interest rates. You know, the higher the risk-free rate is, the wider deal spreads move to offer the proper compensation for the risks inherent in the deal.
So the strategy could also be included in a client's portfolio to hedge out inflation risk.

Jenifer: Thanks, Eric. So what are some of the things you'll be watching for in 2022 that could impact the strategy?

Eric Becker: Yeah, we're gearing up for and expecting another year of robust deal activity. You know, companies have plenty of financial firepower, private equity buyers are flush with cash, and borrowing costs should remain low on a historical basis. So, we expect deal flow to continue to be a tailwind moving forward,

But even with all the catalysts, like the increased volatility and interest rates that I've mentioned, you know, the months and year ahead won't be without its challenges. We understand that. We have been executing this strategy too long not to expect either geopolitical concerns or activist investors to disrupt the strategy. We are constantly adapting to new challenges, and one that has been on our radar, and will continue to be, is the more conservative and rigorous anti-trust process that deals will have to navigate at the Department of Justice and the Federal Trade Commission under the Biden administration. But like I previously mentioned, the challenges that the new regulatory environment have posed are nothing new. And at the end of the day, we're always working on solutions for preserving capital in the merger arbitrage strategies we offer.

Jenifer: Thank you, Eric. So Chris, now I'd like to go to you. I know you were instrumental in the development and design of our AltShares Merger Arbitrage ETF. Can you provide some highlights of that process, and what were your ultimate goals?

Chris Plunket: Thanks Jen. So after identifying a gap in the marketplace, as John described earlier, we spent a few years building this product in-house prior to launching the ETF in May 2020. As veterans in the M&A space, we leveraged the knowledge of our portfolio management team who has been working together on this strategy for over two decades. We tried to think of every scenario that we've seen occur in M&A transactions and how an active manager would approach each one of these situations. Ultimately, we converted all of this experience into a rules-based strategy.

Our intention for this fund was to focus on pure-play, definitive merger arbitrage. We wanted ARB to not only provide exposure to the strategy as other ETFs attempt to do, but to also provide the intended benefits of the strategy. So, we also poured over tons of historical data while building the fund to challenge and validate the structure of each and every rule that shapes the portfolio. We tested our strategy by running live paper portfolios for over a year in-house, and then we conducted further backtests to further validate our rules.

Now, there are so many rules built into this fund we could talk about them all day, but at a high level, all of the rules revolve around our core principles of merger arbitrage which can be distilled down to five main concepts: capturing deal spreads, managing deal risk, minimizing market risk, controlling liquidity impact, and optimizing deal weightings. Each of these concepts are critically important for a merger arbitrage portfolio to meet the risk-return expectations of its clients, while still delivering on the objectives of the strategy. When executed properly, the strategy should provide an absolute return stream with low correlation and low beta to broader equity and credit markets, with low volatility and strong capital preservation characteristics. We kept these objectives in mind throughout the whole development process, and we're very pleased with the final product.

Jenifer: Thank you, Chris. Could you share with us what aspects of ARB you believe distinguish it from its peers.

Chris Plunket: Well, in our opinion, the success of any merger arbitrage strategy is primarily driven by its risk management process, specifically as it relates to deal selection and position sizing within the portfolio. So, while there are many differentiating aspects between ARB and its peers, I'd say the most important one is our focus on measuring and managing the risk associated with every deal that ARB invests in.

We know that an improperly sized position or a deal that lacks proper hedges can wreak havoc on a merger arbitrage portfolio. And for this reason, risk management is embedded in every step of our process. From the initial deal screen, to eligibility and selection criteria, and all the way down to our final weighting process, there are dozens of risk-focused calculations that take place.

I'll give some examples. For every deal we calculate an estimated downside valuation on both the target and the acquirer in the event of a deal break. These downside valuations are initially determined based on a number of data points prior to deal announcement. However, they are constantly evolving and changing as each deal progresses. Once we determine our downside risk, we compare it to the return opportunity based on the stated deal value in order to calculate an implied probability of success for the deal. We then use this implied probability to allocate a max risk budget for each deal relative to the impact that a deal break could cause to NAV. On top of that, we also compare how much risk is coming from the target compared to the acquirer, as this has broader implications regarding overall health of a deal. As this ratio shifts, we scale back that max risk budget accordingly, constraining position sizes smaller. All of this wraps into the final weighting of the ETF at each rebalance.

Now, most rules-based ETFs are weighted by market cap or volume or even equally weighted, but we feel these methods are not appropriate for a merger arbitrage strategy. Our weighting methodology takes these factors into account, but ultimately our ETF is risk-weighted and this is a big distinguishing factor from ARB's peers.

While I'm talking about rebalancing, I'll also mention that the ARB ETF is both reconstituted and rebalanced twice per month. This is more frequent than most ETFs, however, this allows the fund to invest in newly announced deals in a more timely manner. It also allows the fund to reassess any changes in the underlying risk data and make appropriate changes to deal sizing across the portfolio. So, to wrap that all together, we've built this ETF based on the knowledge and experience of our portfolio management team who's been managing merger arbitrage strategies for 20+ years. We combine that knowledge with numerous databases and a quantitative rule set which captures the core principles of a successful merger arbitrage strategy.

With our track record approaching two years, we've been very pleased to see the fund generate positive net returns consistent with our goals of low correlation, low standard deviation, and a differentiated return profile.

Jenifer: Great. So again, we've been speaking with the team behind the AltShares Merger Arbitrage ETF, ticker ARB. John, Eric, and Chris, thanks so much for joining us today.

For those 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 ETFs, allowing clients to choose the best format for their exposure. For more information on us and our funds, please visit our websites at altshares.com and arbitragefunds.com, or call our resource desk at 800-560-8210.

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As of February 18, 2022.

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