

## *Risk Arbitrage Investing*

*“Give a man a fish and you feed him for a day. Teach him how to arbitrage and you feed him forever”.<sup>i</sup>*

**Warren Buffett**

For this issue of the Tapestry SPOTLIGHT we examine the origins of Risk Arbitrage, factors to consider when evaluating this strategy, and its prospects given the prevailing investment climate.

Risk Arbitrage (Risk Arb) is a type of investing that in its simplest form is based upon the completion of an announced event, acquisition or merger transaction. In making this assumption concerning a deal, the arbitrageur purchases the stock of a company that is going to be acquired by another corporation, but is generally trading in the market at a price lower than its deal price. This is referred to as the arbitrage spread. In Risk Arb, the arbitrageur would concurrently short the stock of the acquirer in a stock for stock deal, with the expectation of profit from the arbitrage spread when the deal closes and profits generated from trading activity of the long and short positions.

The history of Risk Arbitrage finds its roots in the numerous takeovers and consolidations that have dramatically changed the business landscape during the last 200 years. In the nineteenth century, the railroad industry dominated business in the US with company listings representing 60% of the New York Stock Exchange. When the great economic depression hit during the late 19<sup>th</sup> century, many of these railroads were unable to service their debt, a large number went out of business, and many others were on the brink of going out of business. In stepped James Pierpont Morgan, who saved a distressed sector by consolidating companies and shutting down overlapping rail lines. This activity set the tone for the merger arbitrage business into the 20<sup>th</sup> century<sup>ii</sup>. The first billion dollar megamerger happened in 1898 when J.P. Morgan combined “Carnegie Steel”, “Federal Steel” and various other steel companies into “U.S. Steel” which is still one of the major steel producers worldwide today.<sup>iii</sup>

The second half of the twentieth century saw three distinct periods of corporate growth prompted by merger activity. The 1960s saw the building of corporate conglomerates as companies tried to diversify their revenue streams and remove the cyclical nature of their core businesses. The second distinct period was in the 1980s, when activists or at that time what were referred to as “corporate raiders” including the likes of Ivan Boesky, who was later forced out of the business because of insider trading, were armed with high yield debt and went after corporations to aggressively restructure and unlock value for shareholders.

KKR’s leveraged buyout of Houdaille Industries in 1979 gave birth to the LBO fund. The buyout represented a \$350 million transaction that was financed with 85% debt. Probably the most publicized and profitable hostile deal in the late 1980s was the battle for control of Macmillan, Inc. , the large US publishing company, brought upon by Texan millionaire and arbitrageur Robert Bass and finally Robert Maxwell of Maxwell Communications who collectively bid the stock up with offers ranging from \$64 to \$90.25 over a condensed time period. The merger frenzy of the 1980s came to an end in 1989 with the United Airlines deal break which wiped out several investors as financing for the deal came up short and liquidity traditionally provided through the junk bond market by the likes of Drexel Burnham Lambert had dried up with the indictment of Michael Milken.

The 1990s witnessed a period of consolidation as corporations sought to scale core business lines, cut costs and improve profitability.<sup>iv</sup> During this period, the use of equity as currency became more commonplace as higher equity valuations made way for attractive purchasing power. This period also brought with it the prominence of risk arbitrage proprietary desks of larger banks like Goldman Sachs, Deutsche Bank and Merrill

Lynch that collectively made substantial profits and led to the spinoff of larger event driven hedge funds like Perry Partners and later Och Ziff.

More recently, Risk Arbitrage players were somewhat wounded as a group. In 2008, leverage used to generate attractive returns constrained their ability to deal with the market's liquidity crisis and proprietary desks at banks cut risk suddenly and in a dramatic fashion. Presently, the Risk Arbitrage community is smaller in number of players and assets, and as a group is hopeful that a less competitive playing field combined with renewed deal activity will make way for more attractive spreads and resultant returns. The regulatory overshadow as to the practices of banks trading this strategy may prove to extend this opportunity to stand alone funds.

Approaches to Risk Arbitrage can vary across a number of metrics including regional focus, market cap focus, deal type, use of leverage, hedging techniques and overall risk and portfolio management. Probably the single most important factor is the sizing of an individual trade in a given portfolio. As noted above with the UAL deal or more recently in the case of GE/Honeywell, deals can break and if a position is too large it can have a detrimental impact on the portfolio's return as potentially the target stock can trade down and the acquirer stock can trade up (losing on both ends of the trade in a stock for stock transaction). Portfolio managers with experience and skill will size positions based on this deal risk to diversify away this trade specific impact. For the small number of deals that do break, the odds of loss are much larger than the return potential and as such deal analysis and position management are thus crucial components.

Announced deals can be all cash, all stock, or a combination of the two and in some instances can include debt instruments. Typically, once a stock for stock deal is announced the arbitrageur will construct the trade to be long the target and short the acquirer to lock in the arbitrage spread. For a cash deal, the arbitrageur will be long the target and may construct a synthetic hedge to alleviate market risks by shorting a broader index or sector ETF. The use of single stock options is also prevalent as managers seek out ways to better utilize their balance sheet. The cash deal has with it more market risk from the perspective of the arbitrageur and currently seems to be the more prevalent "currency" for acquiring companies. This is a function of the low interest rate environment that is coupled with what we believe to be a question of either trepidation over prevailing market volatility or anticipation for a more attractive stock valuation down the road. Stock for stock deals are sometimes structured with collars (caps and floors set on the exchange ratio) to provide more stability to the anticipated exchange price for the deal. These collars take different forms and in some cases can be accompanied by walk away provisions should the price fluctuation become too dilutive to earnings or ownership of shares of a joint merger.

Once a deal has been announced, it is imperative that the arbitrageur structures the trade to lock in the prevailing spread. This spread is traded quite actively and the premium between the market price and offer price will typically narrow/collapse as more traders enter the deal. The anticipated return using a cash deal for example (excluding dividend profits), is defined as the spread divided by the current market price of the target. To generate an annualized return figure one needs to factor in the anticipated time for the deal to close and multiply it by the return. On a stock for stock transaction, by selling the acquirer short the Arbitrageur locks in the spread should the price fall. In some instances, Arbitrageurs may take the reverse position and go long the acquirer and short the target should they feel that the deal will break or may suffer setbacks. This is often the expression of a contrarian view against the prevailing market wisdom. Once the deal is consummated the Arbitrageur receives the shares in the acquirer which then are used to cover the short position in the trade.

The main components in determining the attractiveness of the spread are the time to close, deal risk and financing costs. In reviewing the time to close, the manager must understand the steps in the process and approvals required. This is illustrated in the current hostile offer by BHP Billiton for Potash Corp. of Saskatchewan whereby varied views of Canadian officials and local officials of Saskatchewan have clouded the

prospects and timing for this deal.<sup>v</sup> ‘Deal risk’ is the assessment as to the likelihood of the deal going through. As we witnessed in 2007 with the LBO community, deals like SLM Corporation quickly became painful for investors as the stock dropped substantially during the early days of the financial crisis on news of legislation to cut federal subsidiaries to student lenders (down 15% in July, 2007) and the deal broke between the consortium led by J.C. Flowers and SLM.

In terms of returns for this strategy, they can be cyclical and generally are more attractive during periods of economic growth. Furthermore, in our view the strategy does not carry as much of the downside risk as that of the broader equity markets. When we consider the last 10 calendar years, the HFRI Merger Arbitrage Index has generated an annualized return of 6.3% with an annualized standard deviation of 3.6% in comparison to the S&P500 which has generated an annualized return of -1% with an annualized standard deviation of 16.1% over the same time period. The compounding effect is quite compelling when comparing the full 10 year period resulting in 84.6% for HFRI Merger Arbitrage Index and -9.1% for the S&P500.

In terms of focuses that can be applied to the broader strategy, one can consider geographic focus that can provide an added edge if a hedge fund manager understands the legal and regulatory framework of a particular region. Distinctions are made between regions as to the legal ability to walk away from a deal which is much more difficult in the UK as compared to the US. Arbitrageurs need to keep abreast of anticipated changes as exemplified with the recent statement noted by The Takeover Panel of Britain that they are planning to toughen the rules on hostile offers to correct what they deemed a “tactical advantage” for bidders. This was brought about based on the recent Kraft Foods’ \$19 billion takeover of Cadbury during which Kraft promised to keep a plant open in western England which they subsequently closed down after the deal was consummated.<sup>vi</sup> While there may be no direct impact to arbitrageurs, it provides an example of the regulatory news flow present in this market.

Hedge funds specializing in this type of strategy may choose to participate in as many deals as possible and seek out diversification at all costs or they may be more concentrated and selective, researching the fundamentals of deals and in some cases more complicated deals to gain an edge which hopefully translates into more attractive returns. Fundamental review of where the offer is priced as a function of EBIDTA, EPS or in cases of hard asset plays such as with oil, natural gas and real estate an Asset Valuation may be more relevant. The pricing of the deal also gives some indication if there is room for a higher bid or bidding war which makes the deal more lucrative to the Arbitrageur holding the target stock.

The Risk Arb business and trading the ‘spread’ is a skill that in our opinion is a research intensive process where managers attempt to garner an edge. Hence, we don’t subscribe to the view that Risk Arbitrage is “market neutral” and instead we believe there are many risks that can cause imperfections (basis risk) to the long or short component of this trading discipline (market volatility, deal risk, regulatory changes). With that in mind, we do believe the incorporation of Risk Arbitrage and Event Driven strategies into a multi-manager portfolio provides an independent return stream to other investment disciplines that may have components of more directionality expressed through fixed income, commodity or equity markets.

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<sup>i</sup> Berkshire Hathaway's 1988 letter to shareholders, Warren Buffett.

<sup>ii</sup> Deals, Deals, and More Deals, Regina M. Pitaro,

<sup>iii</sup> Credit Suisse, Understanding merger arbitrage hedge funds, October, 2010

<sup>iv</sup> Deals, Deals, and More Deals, Regina M. Pitaro

<sup>v</sup> Bloomberg Brief – Mergers, October 22, 2010

<sup>vi</sup> Bloomberg Article – Britain Plans Stiffer Rules on Hostile Bids, October 22, 2010