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Merger Arbitrage: Beyond Deal Or No Deal

Merger arbitrage is a classic and time-tested total return strategy that exhibits low correlation to both the stock and bond markets. Although the strategy has existed for decades, its value within a traditional balanced portfolio of equities and bonds is not so widely recognized. This article intends to explore the merger arbitrage strategy further and to take it beyond its traditional use as a hedge strategy in the alternatives space.

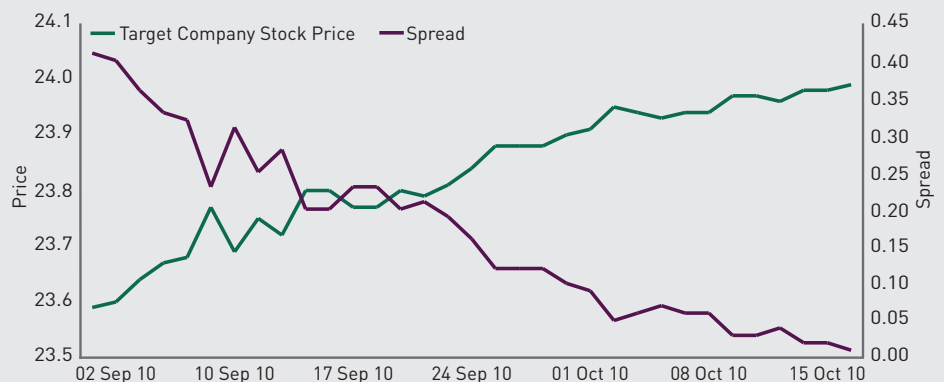
Capturing Deal Spreads

Merger arbitrage strategies aim to benefit from M&A activity by purchasing stock in a target company whose ownership is being transferred to the acquirer. There is often uncertainty about whether the deal will close on time, or even whether it will close at all. Because of this, the target company’s stock will typically sell at a discount to the price that its shareholders will receive when the deal is closed. It is this discount, or “spread”, that merger arbitrageurs aim to capture in order to achieve the consistent and positive returns usually characterized by the strategy. Generally, a bigger spread is indicative of a greater level of risk and potential return.

If the deal involves the transfer of shares from the acquirer to the target company, the merger arbitrageur usually needs to build in some level of protection against the possibility of the acquirer’s stock falling. This can be achieved by buying stock in the target and shorting the acquirer, subject to an exchange ratio, with a view to locking in the spread between the acquirer and the target at the time of purchase.

In both cash and stock deals, as a deal progresses the spread gradually tightens and, upon successful closure, converges to zero. As long as the deal closes, a merger arbitrage strategy will earn the spread, as illustrated in **Figure 1**, irrespective of stock market movements.

FIGURE 1 Example Of Typical Stock Price Movements And Spreads Over Time In Cash Deal



Source: PineBridge Investments, 31 December 2011. For illustrative purposes only.

The absolute returns from investing in a single M&A deal may not seem so impressive. However, since the average holding period is relatively short (it takes on average three to four months from announcement of an M&A to deal close), returns can appear much more compelling if they are annualized across a portfolio of M&A deals. More importantly, the returns are largely uncorrelated to movements in both the stock and bond markets.

Merger Arbitrage Styles

Merger arbitrage strategies can potentially employ a wide range of techniques with varying degrees of risk and expected return, depending on the preference of the manager:

- **Higher risk / volatile return:**

Higher risk merger arbitrage strategies include those that hold concentrated positions, employ financial leverage techniques to enhance return potential or those that speculate on the likelihood that a deal will complete or 'bust', without public agreement by the speculated companies in play. These are essentially similar to event-driven strategies, where the investments are not limited to publicly announced M&A deals. When managing this style of merger arbitrage, if one deal fails, it can cause a big collective draw down. On the other hand, there is a high potential upside.

- **Lower risk / steady return:**

Managers who seek a lower risk approach to merger arbitrage ordinarily only invest in publicly announced M&As and do not use leveraging techniques. These managers endeavour to construct a more diversified portfolio, and need to be sufficiently experienced to undertake the necessary due diligence on the risks of each particular deal. We believe this approach is more likely to deliver steady positive returns and a more consistent level of performance.

For managers who prefer to follow a lower risk approach to merger arbitrage investing, robust and experienced fundamental due diligence research is paramount. Armed with the necessary skills and experience to undertake the depth of deal analysis required to protect against the downside risks, there is significant potential to generate consistent positive returns with lower volatility.

Merger Arbitrage In Practice

1. **As a Market Neutral, Total Return Strategy:**

Merger arbitrage strategies generally exhibit low levels of correlation to the overall movements of the equity market. Since merger arbitrageurs are

anticipating probable outcomes of specific transactions as opposed to predicting sometimes far more random investment variables, the risks are much more manageable.

Furthermore, merger arbitrage strategies are a relatively straightforward and useful way for an investor to introduce some degree of market-neutrality into a portfolio. When investors use merger arbitrage as a market neutral, total return strategy, they not only need to pick the managers that meet their risk/return expectations, but also choose the most suitable investment vehicle (either an unregulated offshore account or a regulated framework, such as a mutual fund or a UCITS). The higher risk / volatile return style usually fits better into an offshore separate account investment vehicle and the lower risk / steady return style can play out well in a regulated, liquid and transparent investment vehicle, such as a UCITS.

2. **As a Portfolio Diversifier:**

The low levels of correlation to market movements associated with merger arbitrage strategies also make it a good diversifier within a balanced portfolio as it tends to enhance overall portfolio returns, while lowering volatility. Figure 2 presents three hypothetical sample balanced portfolios with varying proportions of merger arbitrage exposure, as represented by the Hedge Fund Research, Inc. (HFRI) Merger Arbitrage Index. In the 10-year period ending 2009, introducing a 20% exposure to a merger arbitrage strategy to both traditional balanced portfolios in the hypothetical sample resulted in both higher overall returns and lower volatility.

FIGURE 2		Effect Of Adding Merger Arbitrage Exposure To Balanced Portfolio		
1999-2009	Hypothetical Sample Portfolio 1	Hypothetical Sample Portfolio 2	Hypothetical Sample Portfolio 3	
S&P 500 Index	60%	50%	40%	
Barclays Capital Aggregate Index	40%	30%	40%	
HFRI Merger Arbitrage Index	0%	20%	20%	
Annual Return	2.3%	3.0%	3.7%	
Annual Volatility	9.7%	8.5%	7.0%	

Source: PineBridge Investments, Bloomberg.

Diversification does not insure against market loss. There can be no guarantee that these targets will be met.

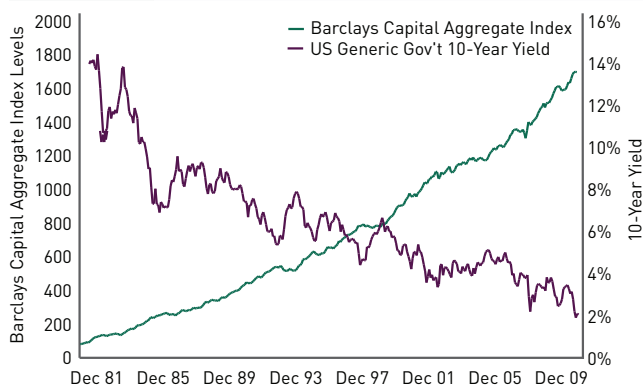
The financial indices referenced herein are not representative of any product and are for informational purposes. They are unmanaged, assume reinvestment of income, where applicable, and do not reflect the impact of any management or performance fees. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified. There are limitations in using financial indices for comparison purposes because such indices may have volatility, credit and other material characteristics that are different from those of the product(s) addressed in this presentation. You cannot invest directly in an index. The performance shown does not represent the results of actual trading, but was achieved by means of retroactive application of the merger arbitrage model designed with the benefit of hindsight. Investors should be aware that the results do not reflect the impact that material economic and market factors might have had on adviser's decision-making were the adviser actually managing client assets.

3. As an Alternative to a Fixed Income Investment:

Fixed income as an asset class has performed well over the past two decades and has therefore been an effective preserver of capital. In fact, investors of long duration fixed income investments have enjoyed price appreciation and income. It is not surprising that most of its outperformance is a result of the protracted cycle of declining interest rates. With 10-year US Treasury yields at 2% and T-bills at 0%, we believe that this interest rate cycle will eventually bottom out and reverse its course. See Figure 3.

We believe that a lower risk / steady return merger arbitrage strategy can be an attractive alternative to fixed income. Since merger arbitrage spreads reflect the cost of capital (3-month LIBOR) plus a risk premium, it follows that a low risk merger arbitrage strategy has the potential to deliver consistently higher returns than LIBOR on an unlevered basis. Although there is continued debate over how long the low interest rate environment will last, investors may find it worthwhile to use a merger arbitrage strategy as a cash enhancement mechanism. When the interest rate cycle turns and rates begin to rise, merger arbitrage returns are expected to rise in conjunction with the LIBOR rate. In this way, a merger arbitrage strategy may be seen as a floating rate note; a natural hedge to increases in interest rates or inflation.

FIGURE 3 US Treasury Yield Vs. Barclays Capital Aggregate Index (Dec 1981 - Nov 2011)



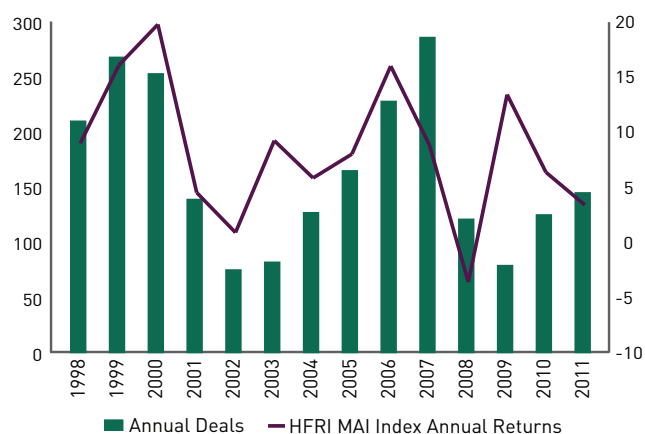
Source: PineBridge Investments, Bloomberg, November 2011.

Merger Arbitrage In Play

M&A has experienced high and low cycles, as Figure 4 illustrates, and each cycle comes with multiple years of development.

Looking forward, conditions that facilitate M&A activity are showing positive signs of improvement. After a sustained period of uncertainty in the market, many corporations have high cash reserves that they have retained as a buffer against potential market shocks. Nevertheless, companies must eventually resume a

FIGURE 4 Deal Volume Vs. HFRI Merger Arbitrage Index



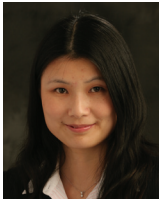
Source: Hedge Fund Research, Barclays Capital Research, December 2011.

growth trajectory, and if they cannot do so organically they will seek merger and acquisition targets to develop their businesses. Shareholders have become increasingly impatient with companies holding high levels of cash that are earning unimpressive zero returns. Additionally, private equity companies have raised a significant amount of capital that is yet to be deployed. Therefore, the M&A cycle is expected to trend upwards. As this plays out, we strongly believe that over time the merger arbitrage investment universe will be filled with broader investment opportunities, and investment managers most adept at sorting the good deals from the bad are set to benefit the most.

Summary

While a merger arbitrage strategy can bring varying degrees of risk, this can be significantly mitigated if the investment manager has the necessary experience to conduct the due diligence required in order to determine whether or not to take a position in an M&A deal. In the right hands, the strategy can be harnessed effectively to produce steady, positive returns, while at the same time reducing overall volatility in a portfolio. In these uncertain times, this is understandably an area of increasing interest to investors and one that merits further consideration.

If you would like further information about this strategy, please contact your local sales representative, or email us at info@pinebridge.com ■



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Ms. Cai joined the firm in 2000 and serves as Lead Portfolio Manager, responsible for managing merger arbitrage portfolios, and overseeing the research enhanced index product and equity income portfolios. She is a key member of the firm's Product Management Committee and Global Asset Allocation Committee. Prior to joining PineBridge Investments, Ms. Cai was Director of Financial Product Research and Development at the CME Group beginning in 1996, where she played an important role in developing financial derivatives products and building the electronic trading system, GLOBEX2. Ms. Cai received an MBA from the University of Chicago and is a CFA charterholder.



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Ms. Sullivan joined the firm in 2006. She is an Assistant Portfolio Manager and Research Analyst for Structured Equities with a primary focus on merger arbitrage portfolios. Before joining the Listed Equity department, Ms. Sullivan spent a year as a Performance Analyst in the Alternatives and Derivatives Performance Measurement Group at PineBridge Investments. Ms. Sullivan received a BA from Brown University in Business Economics & Public and Private Sector Organizations. She is a CFA charterholder.

Data as of 31 December 2011.

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