BEACHHEAD CAPITAL MANAGEMENT

MERGER ARBITRAGE REPLICATION

MID-2015 UPDATE

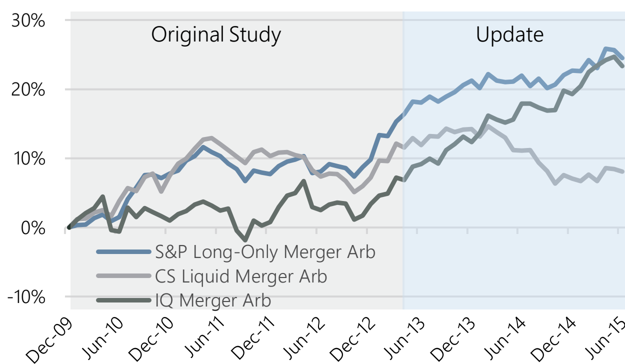
In July 2013, we published a paper on merger arbitrage replication entitled *Merger Arbitrage Replication: How Effective Are Rules Based Indices?* The paper sought to address a few key questions about alternative risk premia investment strategies that rely on rules-based trading strategies. At the time, there were few products with live (as opposed to back-filled) track records, and we sought to compare the performance of those products over time. Based on the data, we reached the following conclusions:

- The complexity of parameter specification leads to very different results and calls into question whether there is a readily-accessible "risk premium."
- There is no evidence that lower costs translate into better returns for investors.
- Selecting products is as complicated, if not moreso, than selecting managers; consequently, investors are swapping "manager" for "modeling" risk, which may actually increase idiosyncratic risk.

This note updates several of the charts from the original paper.

Recent Performance of the S&P, Credit Suisse and IndexIQ Merger Arb Indices

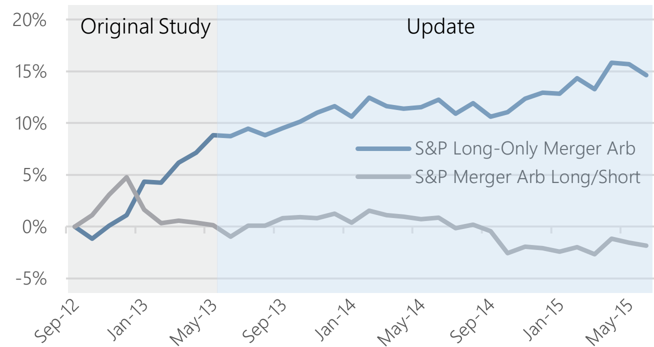
After underperforming dramatically in 2010 – 2012, the IndexIQ model has materially outperformed since January 2013.



The relevant conclusion is that outperformance may not persist and that deviation in performance among models remains widespread.

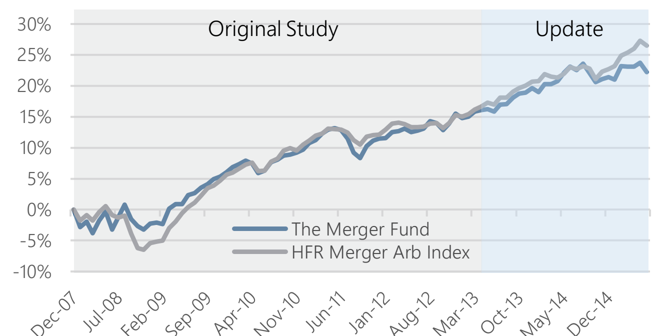
Recent Performance: S&P Long Only vs Long/Short Indices

The continued variation in performance between the S&P Long Only and Long/Short Indices is troubling:



Merger Fund Consistently Matches Hedge Funds

The actively-managed Merger Fund (MERFX) continues to deliver returns close to that of the HFR Merger Arbitrage Index, despite underperforming in the first half of 2015 by 236 bps.



Comparable performance implies that hedge fund managers add value relative to the Merger Fund, but that the added value is paid away in higher fees. Further, given daily liquidity, the Merger Fund materially outperforms on a liquidity adjusted basis (e.g., due to restrictions on accessing capital, investors should demand that hedge funds outperform liquid alternatives by 200-400 bps per annum).

Conclusion

Merger arbitrage generally is considered one of the easiest "hedge fund strategies" to replicate using a rules-based trading strategy. Merger arbitrage spreads may in fact represent an alternative risk premium – where returns are tied to a combination of merger activity, rates and equity prices. The appeal of rules-based strategies is that they can lower costs and reduce idiosyncratic risk – simply by "accessing" the risk premium. However, reality intrudes when different models result in such widely divergent performance. If investors are simply swapping manager risk with modeler risk, and the models don't outperform net of fees, then broader adoption will be tempered.