Hedge funds
Exploring the benefits of equity event-driven strategies – update

CIO WM Research | 12 May 2017
Karim Cherif, strategist; Georg Weidlich, strategist

• The year has started well for hedge funds. The industry as a whole, is reporting year-to-date total returns of up to 3.09% (as of April 2017). Equity event-driven strategies also did well, with special situations and merger arbitrage up 3.26% and 2.01% respectively.
• We think the current environment is conducive for both strategies. M&A activity has been solid so far this year and could accelerate once President Trump sheds more clarity on his reform agenda.
• We recommend investors focus on low-beta managers and advise a 75% merger arbitrage/25% special situations mix within this theme.

Hedge funds shine again
With just one month of losses since February 2016, hedge funds are shining again. Using the HFRI Fund Weighted Index, the industry’s year-to-date performance through April stands at 3.09%, one of the strongest starts to a year in recent history. The performance can be attributed in part to the overall positive trend in risky assets. Alpha generation has also been strong, evidence that managers have been able to find trading opportunities and to take advantage of the current macroeconomic regime. Less monetary easing and more fiscal accommodation combined with an improving economic backdrop and a more event-rich environment should provide a healthy environment for hedge funds as a whole. This bodes well for the remainder of the year. However, not all strategies will perform equally and we think equity event-driven managers are especially well positioned to benefit from the current market environment.

Higher deal value but fewer transactions
Year-to-date, equity event-driven approaches have been among the best performing strategies. Special situations and merger arbitrage strategies are up 3.26% and 2.01% respectively according to Hedge Fund Research (HFR). M&A activity, a driver of equity event-driven strategies, has gotten off to a strong start. According to Bloomberg data, year-to-date global M&A deal value broke through the USD 1 trillion mark in April. This has only occurred on three occasions over the past 15 years – in 2006, 2007 and 2015 – all of which were exceptional years in terms of M&A activity. Most of it, however, is driven by the re-emergence of mega deals (deals above USD 10bn) as volumes have been lower compared to last year.

This report has been prepared by UBS Switzerland AG. Please see important disclaimers and disclosures at the end of the document.
For instance, deals such as British American Tobacco bidding for Reynolds America, Johnson&Johnson acquiring Actelion and Essilor targeting Luxottica together represented more than 10% of global M&A deal value. Uncertainty over President Trump’s tax policies, Brexit uncertainty, elections in Europe as well as increased regulatory scrutiny in China seemed to have forced some companies to remain on the sidelines.

M&A activity should accelerate

This may change. The Trump administration has made a slow start in enacting pro-growth measures. But measures appear to be on the way and should provide a further boost to merger activity in the US. In Europe, while Brexit will continue to hurt volumes, fading political uncertainty could lead to new investments outside the UK. More generally, the trend of companies seeking to acquire targets to complement organic growth remains in place. And with elevated cash levels, executive confidence at a decade high, positive acquirer stock price reaction post announcement and low funding costs, we think all indicators are encouraging. Anecdotally, the first quarter of the year also tends to be among the weakest in terms of transactions, reinforcing our view that transaction volumes should pick-up.

Against this backdrop, risk arbitrageurs should find plenty of opportunities to generate returns. Deal spreads continue to look attractive averaging around 4% to 6%. Special situations funds, which invest more opportunistically beyond just merger and acquisitions transactions, are expected to participate too. Corporate actions such as spin-offs, divestitures, asset sales and restructuring continue at full throttle. Given the managers’ tendency to run their books at substantially higher levels of equity beta, a good performance of equity markets should also be supportive.

Risks

We expect special situations and merger arbitrage strategies to perform well in the coming quarters. That said, several potential risks need to be considered. Such strategies can be sensitive to changes in risk appetite, liquidity conditions, and the direction of equity and rate markets. Investors should remain vigilant of abrupt changes in current market conditions as this could result in losses. This is particularly the case for special situations managers – less so for risk arbitrageurs which tend to be more market neutral. Transaction risks should also be considered. Deal break-ups have been rather low over the past few months but could increase again amid policy uncertainty and/or increased regulatory scrutiny.

Recommendation

We like both strategies, but would focus on merger arbitrage strategies over special situation funds given their more market neutral and defensive positioning. We typically express strategy views within a well-diversified hedge fund portfolio which is part of a broader multi-asset class portfolio. In general, we don’t think it makes sense to take significant market beta exposure in hedge fund allocations as this potentially increases correlations and decreases diversification.
Selected definitions

• **Event-driven**: These strategies tend to focus on debt and equity investments. They capitalize on opportunities arising from corporate transactions such as mergers, acquisitions, reorganizations, bankruptcies and share buyback programs. The preferred instruments are generally stocks or derivatives, but can also include bonds with varying capital structures. The best-known event-driven investment strategies are merger arbitrage, special situations, distressed debt and activist investing. Event-driven strategies are extremely diverse in their choice of instruments and event focus, but they all pursue the same basic goal: to identify potential security mispricing due to uncertainty about the outcome of the event.

• **Merger Arbitrage**: These strategies focus on corporate mergers and acquisitions rather than market direction, and aim to capitalize on deal spreads (arbitrage spreads) – the difference between the market price of the target company and the offered acquisition price.

• **Special situations**: Particular circumstances involving a security that would compel investors to trade the security based on the special situation, rather than the underlying fundamentals of the security or some other investment rationale. An investment made due to a special situation is typically an attempt to profit from a change in valuation as a result of the special situation, and is generally not a long-term investment.

• **Activists**: An individual or group that purchases large numbers of a public company’s shares and/or tries to obtain seats on the company’s board with the goal of effecting a major change in the company. A company can become a target for activist investors if it is mismanaged, has excessive costs, could be run more profitably as a private company or has another problem that the activist investor believes it can fix to make the company more valuable.

• **Distressed debt**: a strategy within the event-driven hedge fund style, focusing on trading securities of companies in financial distress. Primarily investing in listed debt and stocks, managers focus on securities where value can be generated through restructuring. Target companies include those undergoing or likely to undergo debt restructuring (e.g., bankruptcy).

*Source: Bloomberg, UBS CIO*
Non-Traditional Assets

Non-traditional asset classes are alternative investments that include hedge funds, private equity, real estate, and managed futures (collectively, alternative investments). Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Specifically, these investments (1) are not mutual funds and are not subject to the same regulatory requirements as mutual funds; (2) may have performance that is volatile, and investors may lose all or a substantial amount of their investment; (3) may engage in leverage and other speculative investment practices that may increase the risk of investment loss; (4) are long-term, illiquid investments, there is generally no secondary market for the interests of a fund, and none is expected to develop; (5) interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer; (6) may not be required to provide periodic pricing or valuation information to investors; (7) generally involve complex tax strategies and there may be delays in distributing tax information to investors; (8) are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits.

Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program.

In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-U.S. securities and illiquid investments.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer’s “home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a U.S. investor.
Appendix

Chief Investment Office (CIO) Wealth Management (WM) Research is published by UBS Wealth Management and UBS Wealth Management Americas, Business Divisions of UBS AG (UBS) or an affiliate thereof. CIO WM Research reports published outside the US are branded as Chief Investment Office WM. In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS and its affiliates). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS AG, its affiliates, subsidiaries and employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. This report is for distribution only under such circumstances as may be permitted by applicable law. Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Deutschland AG, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS Securities Japan Co., Ltd, UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. UBS Financial Services Incorporated of PuertoRico is a subsidiary of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons, All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the “Municipal Advisor Rule”) and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule. UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect. Version as per September 2015. © UBS 2017. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.