THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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THE WAY FORWARD FOR MERGER ARBITRAGE

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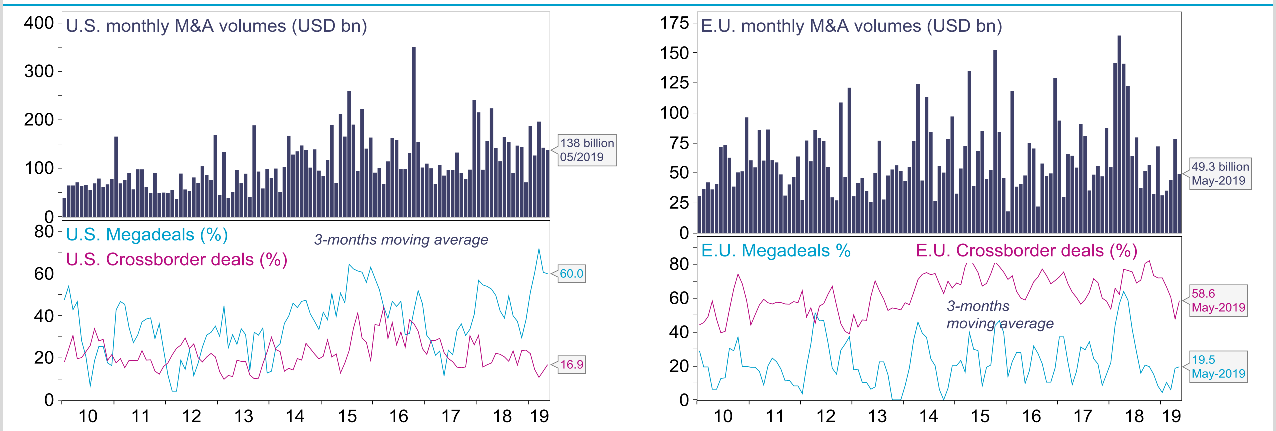
After having delivered upbeat returns in 2018 in relative terms, Merger Arbitrage lagged behind for the first half of 2019. We have analyzed the reasons for this underperformance and the outlook for the second half.

Merger Arbitrage is a defensive strategy within the universe of hedge funds. It has historically delivered buoyant returns in difficult market environments, such as during the DotCom bust in the early 2000s, the Global Financial Crisis a decade ago, and market sell-off episodes throughout the past decade. In 2018, the HFRI Merger Arbitrage was up +3.3% while the MSCI World was down -7.4% and the Barclays Global Aggregate Bond Index was up +1.8%. Merger Arbitrage demonstrated its ability to navigate difficult market conditions last year.

In the first half of 2019, Merger Arbitrage lagged behind for three main reasons. First from a macro perspective, a market driven by central bank dovish announcements is a beta-driven rally. In this context, you cannot expect low beta strategies such as Merger Arbitrage and Market Neutral L/S to join the party. Second, from a fundamental perspective, Merger Arbitrage suffered from tight deal spreads at the beginning of the year. They were caused by lower M&A volumes globally, particularly in Europe and in China. In the U.S., volumes remained strong, but the number of deals has shrunk. U.S. cross border deals have also collapsed to multi-year lows on the back of higher political uncertainty (trade tensions, Brexit). As a result, low deal supply confronting high demand coming from both generalist and specialist investors caused crowdedness and spread tightening. Third, the spread widening in May and June, partly related to new deal announcements and renewed trade tensions, caused mark-to-market losses.

Going forward, the combination of stronger CEO confidence in 2019, lower financing costs, and record levels of private equity dry powder may lead to a supportive environment. M&A volumes rebounded and deal spreads have widened since early May, providing opportunities to deploy capital at attractive entry points. Meanwhile, if trade tensions between the U.S. and China escalate further, the low beta/low volatility features of the strategy will help protect portfolios. We have maintained an Overweight stance on the strategy during the past quarters. On top of better opportunities related to wider deal spreads and higher M&A volumes, strategies which provide protection in bad times are even more appealing in a world of low or negative interest rates.

Merger Arbitrage suffered from tight deal spreads in early 2019, caused by lower M&A volumes



Megadeals are deals above USD 5bn (equity value). Sources: Eikon, Macrobond, Lyxor AM

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PERFORMANCE

CTAs extend their winning streak, up +2% last week

Lyxor UCITS Peer Group Performance

	Last Week*	MTD**	YTD**	# of funds
CTAs	2.1%	3.1%	8.7%	25
MSCI World	0.9%	5.2%	16.2%	
Risk Premia	0.6%	1.4%	3.8%	21
Bloomberg Barclays Global Aggregate Bond Index	0.5%	1.0%	5.6%	
Global Lyxor UCITS Peer Group	0.3%	1.0%	3.6%	246
Global Macro	0.3%	1.3%	3.6%	40
L/S Credit	0.2%	0.7%	3.9%	31
Event-Driven: Merger Arbitrage	0.0%	0.1%	1.6%	22
L/S Equity Directional	0.0%	0.6%	4.1%	63
L/S Equity Market Neutral	0.0%	0.2%	0.3%	37
Event-Driven: Special Situations	-0.1%	0.6%	5.5%	7

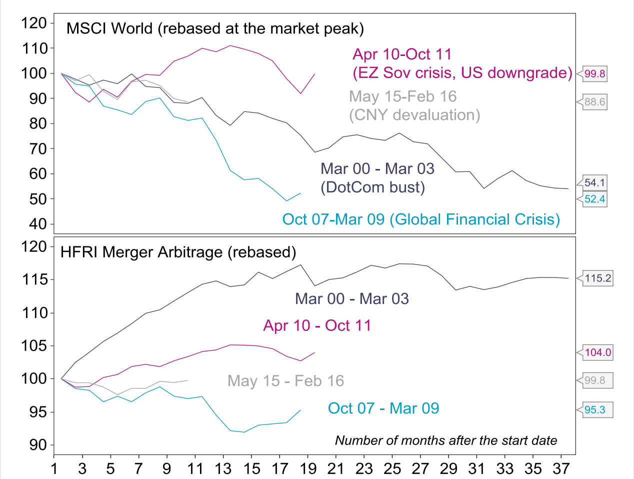
*Last Week: June 11th to June 18th, 2019. ** YTD as June 18th. Source: Lyxor AM

Hedge fund strategies were slightly up during the weekly period under review (+0.3%), as both equity and bond markets experienced positive returns (MSCI World up +0.9% and Bloomberg Barclays Global Aggregate Bond Index up +0.5%).

CTAs extended their winning streak, delivering a very strong performance (+2.1% last week) on the back of long equity and long fixed income positions. It is the best performing strategy year-to-date (+8.7%). L/S Equity and Event-Driven strategies posted flat returns last week.

On a month-to-date basis, EM and Systematic Global Macro strategies outperformed, while L/S Credit returns stayed buoyant. Merger Arbitrage and Equity Market Neutral returns remain flat.

Merger Arbitrage historically delivered buoyant returns in difficult market environments



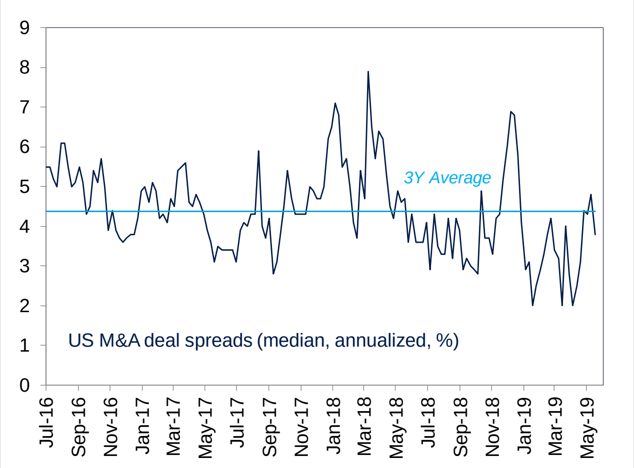
MSCI World in total return and local currency. Source: HFR, Bloomberg, Macrobond, Lyxor AM

Merger Arbitrage was the least volatile hedge fund strategy over the past decade based on HFRI indices (2.3% annualized). Its returns were even less volatile than those of a bond benchmark, such as the Barclays Global Aggregate Bond Index (2.7%).

Its low beta/ low volatility features contribute to explain the outstanding behavior in bad times. Throughout the past two recessions in the U.S., global equity markets experienced huge losses (c. 50% drawdown) and Merger Arbitrage strategies were extremely resilient. They delivered positive returns in the early 2000s and negative returns in the order of -5% during the global financial crisis.

At present, with sovereign bond yields at very low levels, investors have limited options to reduce their portfolio beta unless they are ready to buy negative yielding assets, such as European sovereign bonds.

Recent spread widening caused mark-to-market losses but provides investment opportunities



Net spreads. Deal universe includes spreads in the 0-30% range. Source: UBS, Lyxor AM

Tight deal spreads in Q1-19 have normalized recently, on the back of new deal announcements and renewed trade tensions.

M&A deals requiring SAMR approval widened in May, on the back of fears that China's anti-trust authority will block mergers where U.S. companies are involved in retaliation of higher U.S. trade tariffs. One example is the USD 6.9bn planned merger between Mellanox and Nvidia, two U.S. companies whose merger requires China's approval, as they have operations in the country.

Despite the fact that wider deal spreads caused mark-to-market losses in May, they also provide opportunities to deploy capital. Several strategies have increased their net equity exposure during the past three months.

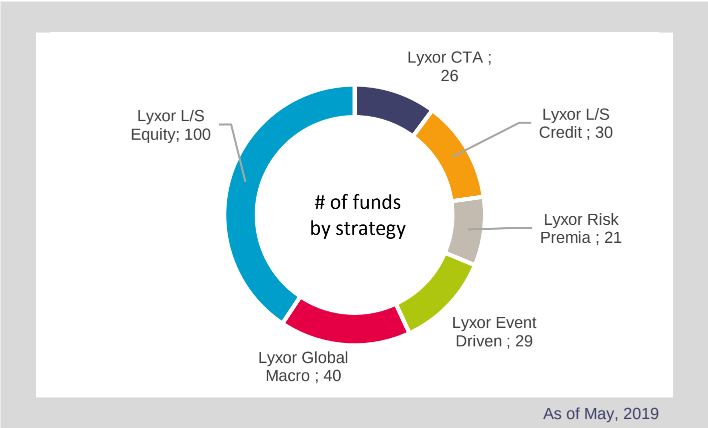
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of onshore hedge funds is based on publicly available information. The universe of underlying funds is relatively stable but varies depending on the criteria of inclusion presented below. It is based on an unbiased selection from our hedge fund analyst team.

Performance is calculated on a weekly basis, as of end-Tuesday, using an arithmetic average (equally weighted average).

Regarding share classes used in these peer groups, we selected the primary share class as referenced in Bloomberg. Non-USD share classes are hedged in USD based on hedging costs available on Bloomberg.

Lyxor Hedge Fund Peer Groups: number of funds by strategy



- 246 strategies across the main categories in the industry
- USD 245 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Strategies are assessed and categorized based on fund prospectuses;

iii) We only include strategies with assets under management of at least USD 50 million; and

iv) We only include strategies with at least a one-year track record.

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