THE WEEKLY BRIEF

By LYXOR CROSS ASSET RESEARCH

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Wide M&A Spreads Not Arbitraged Away By Cautious Managers

Philippe Ferreira
Senior Strategist

Jean-Baptiste Berthon
Senior Strategist

Montassar Jamai
Hedge Fund Analyst

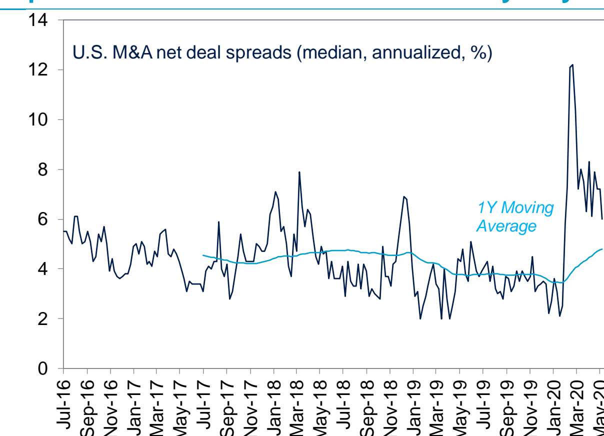
CrossAssetResearch@lyxor.com

M&A volumes have vanished in recent months, but the deal flow appears to be rising from the ashes in June. M&A transactions in the U.S. fell to almost record lows in April and May, with monthly volumes in the range of USD 20 to 30bn per month according to Refinitiv. Mega deals (above USD 5bn) have simply disappeared in the past two months but they could be resurfacing now. Last week, AstraZeneca approached Gilead Sciences over a possible record merger. Many hurdles remain and at the moment, the deal is considered to be unlikely. In the past five years, Gilead Sciences has become much cheaper for Astra, with the former's stock price underperforming the latter by almost 70%.

Despite some green shoots, both dealmakers and Merger Arbitrage managers remain cautious. Deal spreads were volatile in May, as transactions such as Tiffany vs. LVMH and Delphi Technologies vs. BorgWarner entered a period of uncertainty. Expectations have been confounded by deal breaks, which occurred in May for transactions trading at low spreads (Texas Capital vs. Independent Bank; Front Yard Residential vs. Amherst Holdings). Concurrently, some deals trading at wide spreads completed in the energy sector in April (i.e. Tallgrass energy vs. a consortium led by Blackstone).

After having experienced a sharp rebound in April, Merger Arbitrage strategies were flat in May and up almost +1% so far in June according to Lyxor Peer Groups. Their equity market beta has fallen, and fund dispersion remains high, reflecting divergences in risk appetite and positioning. Our stance on Merger Arbitrage remains constructive (Overweight). It might not be the best performing strategy if the market rally goes on uninterrupted, but volatility could come back as the rebound in asset prices has become disconnected with economic and earnings growth expectations. The Merger Arbitrage strategy will likely smooth out market gyrations and with deal spreads close to 6%, it is a source of carry in a low bond yield environment.

Spreads remain wide as deal uncertainty stays high



Deal universe includes spreads in the 0-30% range. Sources: UBS, Bloomberg, Macrobond, Lyxor AM

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Hedge Fund Performance: Global Macro and L/S Credit Outperform So Far in June

Lyxor UCITS Peer Group Performance

	WTD	MTD	YTD
MSCI World	3.7%	5.3%	-2.6%
Global Macro	0.9%	1.6%	-3.7%
Event-Driven: Special Situations	2.1%	3.0%	-5.7%
L/S Credit	1.1%	1.4%	-1.4%
L/S Equity Directional	0.6%	1.2%	-3.9%
Event-Driven: Merger Arbitrage	0.6%	0.5%	-3.0%
Risk Premia	-0.7%	-0.9%	-9.7%
Global Lyxor UCITS Peer Group	0.4%	0.6%	-3.9%
L/S Equity Market Neutral	0.1%	0.3%	-1.8%
50/50 Equity / Bond Index	1.9%	2.7%	1.1%
Bloomberg Barclays Global Aggregate Bond Index	-0.1%	-0.2%	3.2%
CTAs	-1.3%	-2.3%	-4.8%

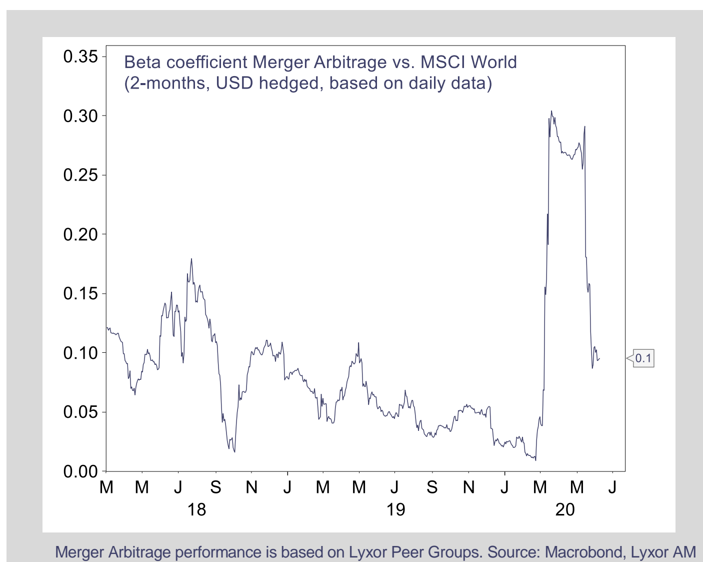
Week-to-Date (WTD): June 2nd to June 9th. MTD and YTD as of June 9th. Source: Bloomberg, Lyxor AM

Lyxor Peer Groups suggest hedge fund performance was up +1% so far in June. The period under review (up to June 9th) excludes the most recent trading days which saw renewed market volatility.

L/S Credit and Global Macro strategies outperformed so far in June, on the back of the rebound of EM assets and the tightening of high yield credit spreads. Meanwhile, CTA strategies continued to underperform due to the rebound in risk assets (including energy) and the rise in bond yields.

Our stance remains constructive on Event-Driven and Fixed Income Arbitrage strategies, Neutral on CTA and Global Macro, and defensive on L/S Equity, particularly Market Neutral L/S strategies.

Equity Beta of Merger Arbitrage Has Normalized at Lower Levels



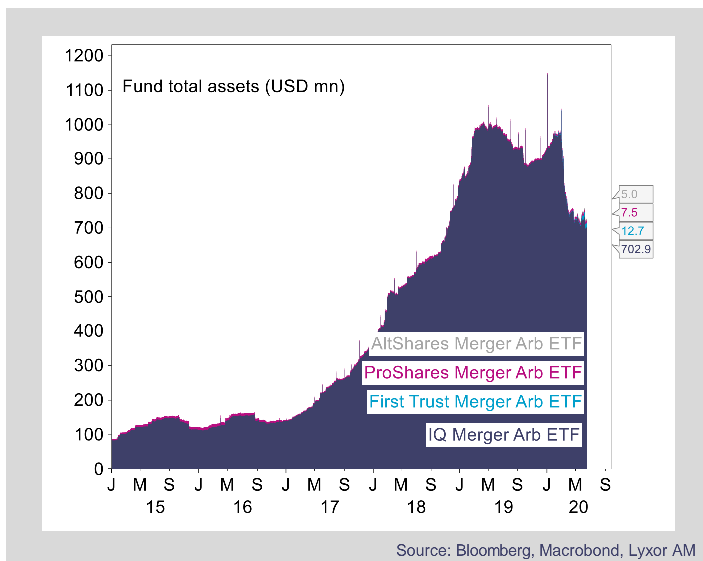
Merger Arbitrage performance is based on Lyxor Peer Groups. Source: Macrobond, Lyxor AM

The equity beta of Merger Arbitrage strategies has remained at higher levels than usual in March and April, when equity markets sold off and then bounced back. It allowed the strategy to partially capture the market rebound in April.

Since then, the beta of the strategy has diminished and normalized at lower levels. This helps explain why the strategy lagged behind in May and has become more resilient now as questions about the shape of the recovery have resurfaced.

Our estimates also suggest that the bond market beta has fallen, though it remains high at 0.4 (based on the coefficient of a 2-months regression with the returns of the Barclays Global Aggregate Bond Index). This signals that the strategy would benefit if bond yields fall.

Passive Merger Arbitrage Strategies: The Cause of Random Deal Pricing?



Source: Bloomberg, Macrobond, Lyxor AM

Some recent developments suggest that markets have faced difficulties pricing in the probability of deal completion. Some "low risk" deals (as measured by low deal spreads) broke, while a "high risk" deal in the energy sector reached completion. This is often referred to by hedge fund managers as random deal pricing. It could be caused by limits to arbitrage (margin requirements/ forced unwinding of highly levered managers/ quantitatively-driven funds) and by the rise of passive strategies that do not discriminate between low- and high-risk deals.

Passive strategies have entered the Merger Arbitrage field in recent years. The largest Merger Arbitrage ETF saw a seven-fold increase in Assets Under Management in slightly more than 2 years, rising from USD 150mn in early 2017 to USD 1bn in April 2019. Other Merger Arbitrage ETFs exist, but they are smaller, with AuMs in the range of USD 5 to 10mn.

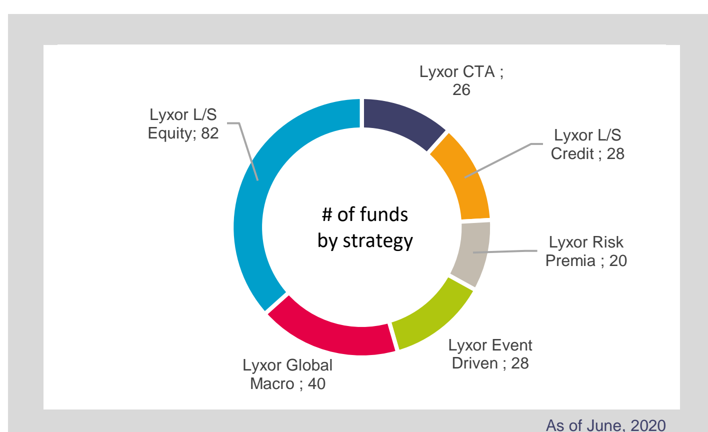
METHODOLOGICAL APPENDIX

The information contained in this report on the performance of 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



- 224 strategies across the main categories in the industry
- USD 167 billion of assets under management

Criteria of inclusion

The criteria of inclusion are fourfold:

i) We only include UCITS strategies;

ii) Assessment by Lyxor's Hedge Fund selection team based on funds' materials or manager interaction;

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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