Alternative Investment Strategies

ETFs REITs Arbitrage Strategies Commodities Structured Investments

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Arbitrage Strategies

Introduction

Arbitrage is the integrated purchase and sale of similar securities to take advantage of any price discrepancies. In the 19th century, the Rothschilds would buy gold in London one day and sell it the next day in Paris, arbitraging any differences in price between the two markets. Merger arbitrage uses arbitrage strategies to profit from changes in stock price related to a corporate merger or acquisition. Arbitrage-focused mutual funds are a convenient way for individual investors to participate.

Company XYZ announces it is going to purchase company ABC for $30 dollars a share in four months, and ABC's stock price is currently trading at $20 a share. ABC's stock price won't immediately move to the takeover price. Because there are risks the deal won't go through or may take longer than announced, ABC stock may only move to $29 dollars a share. The $1 dollar difference, or the "spread", represents the risk that the deal won't go through. This spread is the focus of arbitrage strategies.

Arbitrage focused mutual funds will purchase ABC at $29 and simultaneously short the acquiring company in order to capture this spread, betting the deal will go through and prices will eventually converge at $30.

Example of a Merger Arbitrage Situation

Company A offers $11.50 cash for Company B.
Company B is currently trading at $11.00.

$11.50 target price when deal closes
– $11.00 target price today

$0.50 spread

To calculate the percentage return in this merger arbitrage situation, divide the spread by the target's current price.

$$\frac{\text{spread}}{\text{current price}} = \frac{\$0.50}{\$11.00} = 4.5\% \text{ return}$$

To determine the annualized return on this deal, multiply by a factor equal to the time the deal will take to close. For purposes of this example, assume the deal takes six months to complete.

$$\frac{\text{1 year}}{\text{time to close}} = \frac{\text{12 months}}{\text{6 months}} = 2$$

2 x 4.5% = 9% annualized return

Source: The Arbitrage Fund, www.thearbfund.com

Place in the Portfolio

In theory, arbitrage should be considered riskless, since it exploits a clear price inefficiency. The real world is more complicated and less efficient, however. Retail investors primarily access this strategy through mutual funds. "Do-it-yourselfers," including even large institutional investors, typically use outside fund managers for arbitrage because of the necessary scale involved. Large investments are needed to capture relatively small spreads, and expertise and acumen are required.

Investments in these instruments can result in steady, market neutral returns, typically twice that of the 90 day T-Bill. Allocations to this strategy, which has low correlations to the overall stock and bond market, can lower the overall volatility of a portfolio. Some advisors use arbitrage strategies as a substitute for equity investments. However, the low volatility and regular returns give the strategies similarities to fixed income. The most natural place for merger arbitrage is part of an alternatives allocation. Institutional investors and ultra-HNW individuals have used risk arbitrage investing via hedge funds to diversify their portfolios.

Benefits & Risks

Formerly a strategy primarily used by only a select few, the rise of arbitrage mutual funds now gives retail investors access to this strategy. At the same time, there is always the inherent risk that the merger being arbitraged will not close or may take longer than planned. Mutual funds try to diversify away this risk by investing in up to 50 or 60 deals simultaneously. Returns and risks vary by the amount of leverage used.

Additional risks within an arbitrage mutual fund include turnover and options risks, which can decrease performance and increase costs. In order to minimize market exposure and volatility, merger arbitrage typically utilizes extensive hedging strategies including the use of options. Hedge funds use leverage to amplify any spread.

One of the most useful features of arbitrage strategies is their low correlation with the markets. Although these funds tend to be small, some of the most successful performers have shown that higher costs have not unduly hurt results. ■

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