Investing in change

The case for event-driven strategies

welcome to brighter
The case for event-driven strategies

Event-driven strategies are a key component of a diversified hedge fund program. We believe event-driven strategies present a compelling opportunity in the current environment. This article provides an overview of the strategy and sub-strategies, investment outlook, and implementation considerations.

What are event-driven strategies?

Event-driven strategies seek to take advantage of companies undergoing change. In many instances, these opportunities help allow a skilled manager to seek opportunities, events or catalysts created by, or as the result of, an economic or business cycle, resulting in a relatively consistent hunting ground for alpha. Event-driven managers capitalize by speculating on the movement of security prices that occur in anticipation of, or following, a catalyst. Catalysts are often characterized as ‘hard’ or ‘soft’; hard catalysts tend to have a more defined outcome and timeline (i.e. announced merger, bankruptcy, spin-off, buybacks), while soft catalysts can have a wider range of outcomes and may be more nuanced in nature (i.e. earnings turnaround, management changes, new product launches, special situations).

Depending on the nature of the event or catalyst, either relative value (merger arbitrage, capital structure arbitrage) or directional positions (bankruptcies, liquidations) can be taken. Successful managers will typically have a deep understanding of the transaction, legal and regulatory skillset, combined with expertise around the company and industry.

Event-driven is a broad category encompassing a number of underlying disciplines. Below we highlight a few common sub-strategies:

- Merger arbitrage is an event-driven strategy that seeks to profit on a merger or acquisition announcement. The acquisition offer is generally at a premium to current market values. A standard trade is to invest long the target company and short the acquiring firm, seeking to profit as the prices converge when the deal closes, while reducing industry- and market-specific risk and isolating the deal premium. Post announcement, a spread often exists between the offer price and market price for the target, representing the market uncertainty on the deal closing and often a time-horizon premium. Applying modest amounts of leverage to a successful merger arbitrage trade can offer attractive risk/reward that tends to exhibit low correlations with equity markets or even other hedge fund strategies.

- Activism strategies seek to effect corporate change through meaningful ownership stakes and often representation on a company’s board of directors. Through direct engagement with senior management teams, an activist manager will look to influence corporate polices or strategic direction, including asset sales, divestitures,
share buybacks, and changes in management, to name but a few. Increasingly, these efforts might include advancing ESG and Diversity and Inclusion policies all in an effort to further unlock value. The strategy can offer strong alpha potential, as the value delivered hinges on the effectiveness of the activist manager driving change and value.

• Distressed investing seeks to capitalize on dislocations often created by stressed or distressed corporate balance sheets and liquidations. The distressed investor serves as a liquidity provider in the market, as credit downgrades and solvency concerns can provide forced sales by certain market participants, providing further uncertainty and valuation dislocations. By invoking creditor rights through a formal bankruptcy or voluntary restructuring, distressed managers are often in a position to drive process, repair financial standing and deliver value through the process, and as corporations look to exit bankruptcy and resume access to capital markets.

• Special situations is a catch-all bucket employing a variety of event-driven strategies based on a number of catalysts. Special-situation managers often invest in events that are not well understood or anticipated by the market, and often involve a degree of complexity. Often, this may not include a formal announcement. Examples include spinoffs, asset sales, product launches, etc. Identifying these opportunities and their impact ahead of the market can deliver attractive results.

• SPACs1, while not a major event-driven category, have become more popular and topical recently. SPACs, also known as blank-check companies, are an alternate way for management teams to take a company public. They are formed with the sole purpose of raising capital through an initial public offering (IPO) to purchase a single, unidentified, pre-existing company. Benefits include limited downside (opportunity cost of holding the capital), potential for an attractive upside, and optionality with several ways to participate in a SPAC. SPACs are, however, not without risk and include a number of unique considerations, offering opportunities for skill to add alpha.

Mercer’s event-driven universe includes a mix of specialists within these disciplines, as well as multi-strategy diversified solutions that invest across a range of event strategies.

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1 See SPAC paper, August 2021: https://www.mercer.com/our-thinking/wealth/understanding-the-spac.html
Why invest?

Often, the outcomes of identified events (and corresponding risk positions) are less market-dependent, with the event or catalyst being the primary mechanism for value creation. Further, relative value opportunities often allow for partial hedging, or offsetting of certain risk exposures. The net potential benefits of incorporating event strategies are quite powerful, as outcomes can be counter-cyclical to the economic cycle with often low correlation to broad markets. A portfolio of diverse corporate events can act as a diversifier within a broader asset allocation, as well as a potential differentiated alpha source. As indicated in Figure 1, broadly event-driven results have been mostly positive over the trailing five calendar years and year to date.

Figure 1. Calendar year performance for event-driven hedge fund strategies

![Figure 1. Calendar year performance for event-driven hedge fund strategies](source)

Investment outlook

As mentioned in recent papers, we believe the environment for hedge funds is improving with a strong and favorable outlook, event-driven opportunities included.

Event-driven managers are seeing a strong pipeline of activity in the current environment. Throughout this pandemic, companies are almost universally forced to prop up their balance sheets in order to survive during a prolonged period of uncertainty. Companies are facing increasing pressure to improve top-line growth, increase efficiencies, and reduce costs. One avenue to help advise this is acquisition. Another source of optimism comes from continued accommodating interest rates and financing, along with a war chest of capital through private equity. As a result, we
believe the opportunity set is primed for increased merger arbitrage activity, creating a strong environment for event-driven managers, particularly should valuations come down. Merger volume remains elevated, with attractive premiums on average due to increased regulatory uncertainty. Through the first half of this year, volumes were on pace to meet or exceed the recent past.

**Figure 2. Global merger volume and spread**

![Chart showing global merger volume and spread](source: Bloomberg, Q2 2021)

Increased pressure on management teams to recover from the pandemic slowdown and return to a path of growth is likely to lead to creative solutions. We expect the opportunity set will be ripe for announced and unannounced special situations and activist opportunities, as corporations introduce strategic plans. Indeed, we have seen a number of activism campaigns announced already in 2021 and we expect this will continue, given we may be approaching an inflection point in the cycle.

Heading into 2020, the general consensus was that the global economy was in the late innings of what had been an extended credit cycle, beginning in mid-2009. The pandemic demanded government and central bank responses with unprecedented speed and stimulus measures to support markets. The result was a mini cycle, without the usual deleveraging, as a result of the stimulus packages and a resumption of financing spigots. We believe sound balance sheets are likely to lead to increased corporate activity, some of which will be used for share buybacks, as management teams look for capital allocation options.

While the continuation of stimulus policy has provided strong economic support, a decade of low rates and accommodative global central bank policies has led to increased leverage on balance sheets, with non-financial corporate debt as a
percentage of GDP at record levels. We expect the impact of the pandemic to have lasting effects, with an increasing number of companies likely to face liquidity and solvency issues over the coming years. Absent significant fiscal and monetary support, the pressure and pain in corporate credit markets could be exacerbated by a lack of dealer inventories and the mountains of capital in ETFs and mutual funds offering instant or daily liquidity. The deleveraging phase should provide a strong opportunity set for distressed managers with an increase in defaults, bankruptcies, and restructurings.

Figure 3. US non-financial corporate debt as a percentage of GDP

![Chart showing US non-financial corporate debt as a percentage of GDP from 1990 to 2018. The debt peaked at 51% in 2018.](https://fred.stlouisfed.org/series/BCNSDODNS)

SPACs have grown in popularity over the last two years, indicative of the current event cycle, creating a plethora of opportunities for event-driven managers with multiple paths to participate. Strategies include pre-target announcement, Private Investment in Public Equity (PIPE) financing arrangements which provides additional capital to help the business grow, de-SPACing (post acquisition), secondary trading, arbitrage opportunities between warrants and unit shares, and shorting opportunities that are overvalued or expected to falter. The amount of capital raised for SPACs in 2021 has already exceeded that in 2020, with increased competition to find an attractive target company. Event-driven managers that have the appropriate resources and skillset should add value through their ability to evaluate and identify attractive SPAC deals.

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Implementation considerations

Like any investment strategy, event-driven has unique considerations that need to be taken into account prior to implementation. The time horizon and liquidity concerns necessitate a dedication and commitment and often require a medium- to long-term time horizon.

Many event-driven strategies carry a short volatility profile, meaning they may be subject to drawdowns when markets are risk averse and volatility rises. While event-driven strategies have provided moderate diversification benefits over a full cycle, benefits may be lessened during times of crisis, particularly when complexity and longer horizon opportunities might be shunned. Though crisis periods may impair performance, they have historically provided attractive opportunity sets on a forward-looking basis.

Deal dynamics are also a factor. Transaction risks, such as policy uncertainty or regulatory scrutiny, may cause deals to break. The risk has increased in an environment of political populism, increased skepticism towards globalization and a desire to make supply chains more resilient and localized. This is leading to additional scrutiny of transactions, especially cross-border deals or strategic industries. The ability to influence or drive change often requires meaningful or majority stakes and may involve investor restrictions. Event-driven strategies, particularly distressed and activism approaches, may be subject to headline risk.

Underlying strategies are cyclical. Different phases of a market cycle typically offer different opportunities and may favor different positioning and overall results. Timing the cycle is challenging. We favor a long-term, all-weather allocation to event-driven. In our opinion, a multi-strategy, event-driven approach may serve to smooth the cycle effects and allow for improved capital allocation across a relative risk/reward construct. Our general performance expectations across event are 5-9%, net of fees over a full market cycle with equal or less volatility. Given the favorable backdrop, this may be improved for the immediate future. Of course, ultimately, manager selection and execution will determine success.
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