THE WEEKLY BRIEF
By LYXOR CROSS ASSET RESEARCH

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MERGER ARBITRAGE FLEXES ITS MUSCLES

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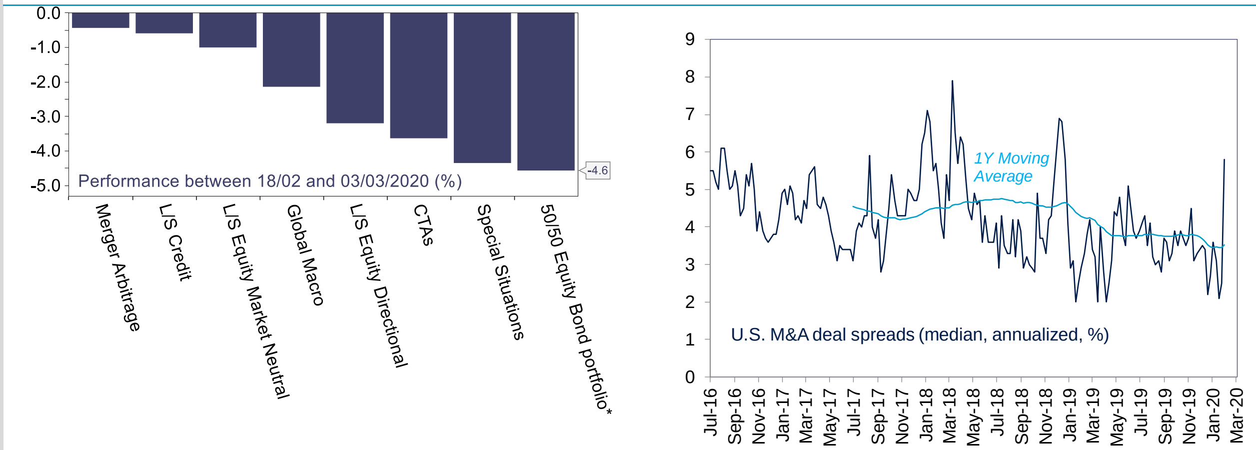
Merger Arbitrage has been the most resilient hedge fund strategy during the recent market sell off. The ability of the strategy to protect capital in bad times is something we underlined in the past and which is based on historical evidence (see page 2). This contributes towards explaining why we have been and remain highly constructive on the strategy (at Overweight). Since February 18th, the equity market peak, Merger Arbitrage is down -0.4%, while a 50/50 portfolio of equities and bonds is down -4.6% (based on MSCI World and Barclays Global Aggregate Bond Index, up to March 3rd). The strategy was resilient in a context where deal spreads were stable up to February 28th and widened afterwards.

Concurrently, cash levels in portfolios where elevated in early 2020. Seasonal factors, along with the tightness of deal spreads and the completion of several transactions in Q4 all contribute towards explaining why Merger Arbitrage strategies had elevated cash levels before the selloff. The recent widening of deal spreads (see chart) thus brought opportunities to deploy capital in high conviction deals, i.e. those with an attractive risk reward profile. Gross spreads on friendly deals have gone from 1% to roughly 2-3% in recent days. Managers started to deploy capital in a number deals that they have already been invested in, such as Allergan vs. AbbVie and Tiffany vs. LVMH, to name a few. Managers also deployed capital in recently announced transactions such as HP vs. Xerox, E*TRADE vs. Morgan Stanley and UBI vs. Intesa. For some managers, we have seen gross exposures climbing significantly, from 60-70% to 90-100% of net assets.

Apart from Merger Arbitrage, it is important to highlight the fact that L/S Credit and EM Macro strategies have also been resilient since Feb 18th (-0.6% and -1%, respectively). Our stance remains at Overweight on both strategies. On a negative note, CTA and Directional L/S Equity strategies underperformed during the same period (-3.6% and -3.2%, respectively). Our stance remains at Neutral and Underweight, respectively. Yet, within these strategies, dispersion is elevated. The best performing CTA and Directional L/S within our samples still managed to post positive returns during this troubled period.

Merger Arbitrage has largely been isolated from market volatility; widening deal spreads as an opportunity



* Based on the MSCI World and the Barclays Global Aggregate Bond Index (net total return, USD hedged) Sources: Bloomberg, Lyxor AM

Hedge Funds have met expectations in such market circumstances

Lyxor UCITS Peer Group Performance

	Last Week*	MTD	YTD	# of funds
MSCI World	-4.4%	1.4%	-7.0%	
L/S Equity Directional	-1.5%	0.5%	-2.4%	63
CTAs	-1.9%	0.4%	-0.1%	25
Global Macro	-1.2%	0.4%	-1.3%	48
Bloomberg Barclays Global Aggregate Bond Index	0.7%	0.3%	3.3%	
Global Lyxor UCITS Peer Group	-1.2%	0.3%	-1.3%	244
L/S Credit	-0.5%	0.1%	0.6%	29
Event-Driven: Merger Arbitrage	-0.4%	0.1%	0.1%	22
L/S Equity Market Neutral	-0.4%	0.0%	-0.9%	29
Risk Premia	-2.3%	0.0%	-2.9%	21
Event-Driven: Special Situations	-2.4%	-0.1%	-4.2%	7

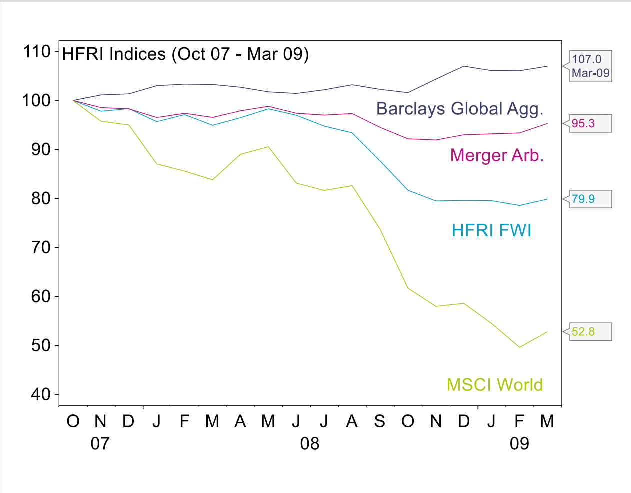
*Last Week: Feb 25th to Mar 3rd. Source: Lyxor AM

Risk assets experienced wide gyrations as the spreading of the COVID-19 will probably cause sharp losses in economic activity in Q1 and potentially in Q2.

In line with the previous week, hedge fund strategies outperformed traditional markets. The Global Lyxor UCITS Peer Group was down -1.2% last week, versus -4.4% for the MSCI World and +0.7% for the Barclays Global Aggregate Bond Index. CTAs underperformed due to their short EURUSD and long equity positioning. But the losses were overall contained thanks to long positions on fixed income and precious metals. They have cut their long equity positions since mid-February.

Since the virus outbreak in early 2020, L/S Credit, Merger Arbitrage, and Market Neutral L/S strategies outperformed, due to their low market directionality.

How Merger Arbitrage fared in bad times



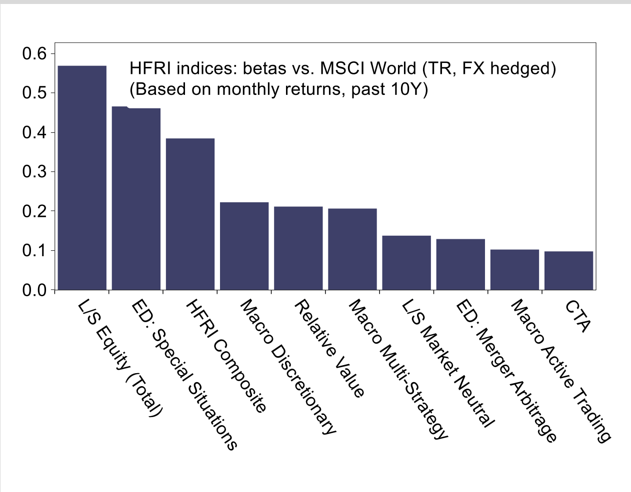
Source: Bloomberg, Macrobond, Lyxor AM

Merger Arbitrage is a strategy that has historically been resilient in bad times, when risk assets sold off severely.

During the Global Financial Crisis in 2008, the strategy was down less than -5% while the MSCI World was down almost -50% (from October '07 to March '09). Such pattern is also observable between 2000 and 2003. During this period, Merger Arbitrage was up +15% when the MSCI World was down -45%.

How can we explain such resilience? First, Merger Arbitrage is a low beta strategy. Over the past twenty years, we estimate its beta versus the MSCI World at below 15% (based on HFRI). It is thus structurally somewhat isolated from wider market moves. Second, Merger Arbitrage is an active strategy. Under such circumstances, managers have reduced the duration of the portfolio and concentrated it on high conviction deals.

Which strategy in current market conditions?



Source: HFRI, Macrobond, Lyxor AM

The spreading of the COVID-19 globally and the measures adopted by the authorities to mitigate it are causing a sharp slowdown/ contraction in economic activity. Markets have been particularly volatile as the probability of a global recession (i.e. two consecutive quarters of negative growth) increased.

In a worst-case scenario, the selloff continues for several months. CTAs, Merger Arbitrage, Global Macro, and Market Neutral L/S would be our preferred strategies to protect portfolios in this scenario.

Our base case is that risk assets stay volatile in the coming weeks but eventually bounce back in early Q2. In this scenario, L/S Credit and Global Macro would face hurdles but still outperform, while Merger Arbitrage would remain the outperforming strategy.

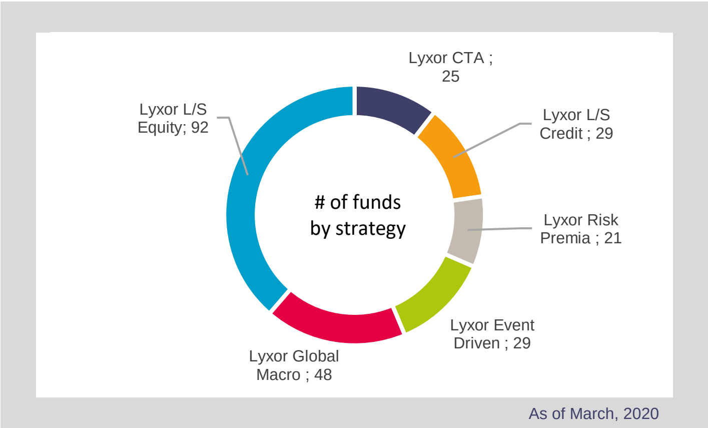
METHODOLOGICAL APPENDIX

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



- 244 strategies across the main categories in the industry
- USD 208 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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