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Event hedge fund primer: alpha from corporate catalysts

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In summary

Event driven hedge funds focus on exploiting pricing inefficiencies caused by corporate events such as mergers, acquisitions, restructurings, bankruptcies, or other significant corporate actions. The strategy identifies mispriced securities with favourable risk/reward characteristics based upon differentiated views of value-unlocking catalysts, event probabilities and post-event valuations. The success of such strategies is dependent upon the manager's ability to predict the outcomes of these corporate events accurately and manage the associated risks effectively.

In this article we explore event driven investing, offering insights into the most common event driven strategies. For each strategy, we provide a description, sample trades, and review how each has historically performed in different market environments, considering the unique risk and return profiles associated with these strategies.

> **The success of event strategies is dependent upon the manager's ability to predict the outcomes of corporate events accurately and manage the associated risks effectively.**

What are event driven hedge funds?

Event driven hedge funds deploy investment strategies that capitalise on opportunities arising from specific corporate events. These events include mergers and acquisitions (M&A), spin-offs, restructurings, bankruptcies, and other significant corporate actions. The strategy involves analysing the potential outcomes of these events and their likely impact on the prices of the involved securities, exploiting market inefficiencies and idiosyncratic risks associated with these events.

Event driven managers require a deep understanding of event dynamics, the regulatory environment, and potential market reactions to make informed investment decisions. This often requires specialist knowledge and expertise in areas such as fundamental analysis, legal considerations, credit analysis, market dynamics and corporate strategy. While event driven strategies are primarily expressed via equities, credit instruments such as corporate bonds can also feature in more credit-oriented situations, including bankruptcies, restructurings, and catalyst-driven upgrades or downgrades to credit ratings.

Event driven strategies face specific risks related to the events they target, including delays or failures in event completion due to regulatory hurdles, shareholder opposition, or unexpected changes in corporate strategy. General market conditions and economic factors can also influence the success of event driven strategies, particularly in volatile or uncertain market environments that may impact the feasibility of event completion. Assessing liquidity is crucial, as event driven opportunities can attract many managers, leading to crowded trades. This risk has intensified with the proliferation of event driven sub-strategies within multi-strategy fund structures in recent years.

Most common event-driven strategies

Event driven funds can be categorised in various ways; however, the sub-strategy classifications used in this primer align with those employed by Aurum's Hedge Fund Data Engine, as follows:

- **Activist**
- **Merger arbitrage**
- **Event – multi-strategy**
- **Event - opportunistic**

Activist managers are classified as event driven because they actively seek to create the catalysts that will increase shareholder value. They typically take significant positions in companies to influence management decisions and drive corporate actions, such as restructuring, spin-offs, or changes in corporate governance.

Merger arbitrage funds specialise in capitalising on the price differential between the current market price of a target company's shares and the agreed-upon acquisition price in a merger or acquisition (M&A) deal. This spread reflects the market assessment of the perceived risk and timing of the deal closing, providing arbitrageurs with an opportunity to profit from the completion of the transaction.

Event – multi-strategy and event – opportunistic funds are characterised by their diversified approach, investing across multiple event driven sub-strategies. Alongside activism and merger arbitrage, these funds may also allocate to event driven credit and special situations. The latter is a broad category encompassing diverse, less tangible catalyst events, typically focused on companies undergoing significant changes in either corporate or capital structure. Special situations can also include more arbitrage-oriented strategies such as share class arbitrage, dual-listed arbitrage, capital structure arbitrage, and holding company/stub arbitrage. Event – multi-strategy and event – opportunistic funds may also deploy liquidity provision strategies, including index rebalancing and equity capital market (ECM) strategies.

While both types of funds can dynamically allocate capital across sub-strategies, the defining characteristic of event – opportunistic funds is their highly flexible and opportunistic approach. These funds may concentrate a significant portion — or even all — of their risk in a specific area based on the prevailing opportunity set. This approach differs from event – multi-strategy funds, which typically remain allocated across multiple sub-strategies at all times, with changes occurring less frequently or dramatically than event – opportunistic funds.

These funds may also allocate a portion of their capital to distressed credit situations, which can also be considered a part of event driven investing. However, if the majority of the fund's risk or P&L is consistently driven by the strategy, such funds will be classified under Aurum's credit – distressed credit category. The definition of the sub-strategy can be found here.

Event driven hedge fund strategies represent a relatively modest segment of the hedge fund universe. According to Aurum's Hedge Fund Data Engine, these strategies account for approximately 10% of the total assets in the hedge fund industry. Nevertheless, event strategies also form a staple component of the larger multi-strategy space, typically comprising between 5-15%+ of the overall allocation.

Risk/return summary

	Activist	Merger arbitrage	Event – multi-strategy	Event - opportunistic
Typical assets traded	Equities	Primarily equities, but may also trade related derivatives and/or credit instruments	Equities and credit, including derivatives thereof	Equities and credit, including derivatives thereof
Directional or relative value bias	Directional	Directional or relative value depending on the composition of cash transactions and stock-for-stock transactions	Primarily relative value	Variable
Long/short bias	Long-biased	Typically long-biased, depending on the composition of cash transactions and stock-for-stock transactions	Typically no bias	Variable
Observed beta to traditional risk assets	High	Low	Low to Medium	Variable
Historical volatility relative to other hedge fund strategies	Above average (among the highest)	Below average (among the lowest)	Below average	Variable
Liquidity of underlying securities typically traded	High	High	Variable	Variable, dependent on the underlying sub-strategy
Typical leverage	Low to medium	Low to medium, but manager dependent	Medium to high	Variable

Activist

DESCRIPTION

Activist hedge funds invest significant stakes in publicly traded companies with the goal of influencing corporate decisions and driving changes to enhance shareholder value. Unlike other hedge fund strategies that may also engage with management, such as distressed investing and certain special situations, activist managers are particularly focused on being the catalysts for change. They typically employ a value-oriented mindset, with investment decisions typically based on in-depth fundamental analysis and a proactive approach to influencing corporate strategy. Activist strategies typically focus on:

- Operational improvements
- Capital structure optimisation
- Strategic alternatives (such as M&A)
- Corporate governance reforms
- Shareholder-friendly policies (like buybacks or dividends)

Target companies

Activist hedge funds tend to target companies where they see clear pathways to enhance shareholder value through active involvement. These are often firms that have made poor strategic decisions, inefficient capital allocation, excessive executive compensation, or suboptimal governance structures. Conversely, they usually avoid companies where their ability to influence change is limited or where the pathway to value creation is less clear.

Engagement methods

Activist managers often take substantial equity positions to gain influence and can engage in either public campaigns or private negotiations to advocate for their proposed changes. The time horizon for activist investments can be longer than other hedge fund strategies, often spanning several years, as the process of enacting change and realising value can be protracted.

Risks and challenges

While the activist approach has been associated with significant successes and high-profile campaigns, it also carries risks. Companies may resist change, and public battles can be costly and time-consuming. Additionally, the market may not always respond favourably to activist interventions, particularly if the proposed changes are seen as too aggressive or detrimental to the company’s long-term prospects.

Historical evolution

Activist investing has evolved over the years, leading to distinctions in style and approach. Early activist investors in the 1980s and 1990s, often referred to as "corporate raiders," were known for hostile tactics and aggressive public campaigns. Modern activists, however, tend to adopt a more collaborative and constructive approach, seeking mutually beneficial outcomes through engagement with management. This evolution has seen activist funds diversifying their strategies, combining traditional activism with elements of private equity and strategic advisory roles.

Active short sellers

A distinct subset of the strategy worth highlighting separately includes activist short sellers; managers that aim to profit from the anticipated decline in a company's stock price. These managers typically publicise their research findings, highlighting issues such as fraudulent accounting practices, misleading disclosures, or unsustainable business models. Their reports can lead to immediate declines in the target company's stock price, potentially destabilising its market position and investor confidence.

While activist managers can often attract controversy owing to their public criticism of management or other aggressive tactics, activist short sellers are particularly contentious due to their emphasis on short selling. Such managers can face accusations of market manipulation and spreading negative information to drive down a company's value. These strategies can result in legal and ethical debates about their impact on market stability and corporate integrity, however, advocates argue that activist short selling enhances market efficiency by exposing fraudulent or unethical practices, thereby protecting investors and promoting transparency and price-discovery.

SAMPLE TRADE

One high-profile activist campaign in recent years was the campaign launched by Elliott Investment Management L.P. ("Elliott") against the technology giant, Twitter, in 2020[1]. This campaign drew significant attention due to the high-profile nature of the target company and its influential CEO, Jack Dorsey.

Campaign overview:

- Stake accumulation: Elliott initiated the campaign and disclosed a significant stake in Twitter, reportedly around 4%, making it one of the largest shareholders.
- Strategic intent: Elliott publicly pushed for changes aimed at enhancing shareholder value, including potentially replacing Jack Dorsey as CEO. They argued that Dorsey's dual role as CEO of both Twitter and Square (another company he co-founded) was not in the best interest of Twitter's shareholders.
- Engagement tactics: The hedge fund reportedly engaged in private discussions with Twitter's board and management, advocating for operational improvements and a more focused leadership structure, nominating four directors to Twitter's board in the process.
- Public scrutiny: The campaign received substantial media coverage and scrutiny, given Twitter's influence in social media and technology sectors, as well as the high-profile nature of CEO leadership challenges.
- Outcome: Ultimately, the campaign led to significant changes at Twitter. In November 2021, Jack Dorsey stepped down as CEO. The change in leadership was seen as a partial success for Elliott, aligning with their goal of improving governance and operational focus at Twitter.

This activist campaign by Elliott against Twitter exemplifies how hedge funds strategically leverage their stakes to influence corporate governance and management decisions, aiming to unlock shareholder value.

PERFORMANCE IN DIFFERENT MARKETS

Activism has less of a clearly identifiable inflection point between a good and bad environment. That said, the long-biased nature of the strategy means that the overall direction of equity markets can play a significant role in the performance of activist managers. A broad upward trend in equity markets can support the appreciation of targeted companies' shares, enhancing the potential for the strategy to generate returns. Conversely, declining equity market conditions can diminish the value of activist-held stocks, making it harder to achieve the desired returns and potentially prolong the time required for the market to recognise and reward the changes implemented by activist managers.

However, it is also more challenging to effect change in a rising market, as finding targets where significant value can be unlocked through activism becomes more difficult, with shareholders also less likely to be displeased with current performance. Opportunities for activism tend to be more fruitful during periods of corporate distress, where companies may be more vulnerable to activist pressure and more likely to accede to demands for strategic changes.

Lastly, sector-specific dynamics can also affect the performance of activist strategies. Sectors undergoing rapid technological change or regulatory disruption (technology, healthcare, consumer goods) often present more opportunities for activists to advocate for strategic shifts. In contrast, more stable or heavily regulated sectors (utilities, financials, real estate) can pose greater challenges for activist interventions, as stringent regulations or policies can serve to protect entrenched management and hinder activists' ability to effect change.

[1] *Aurum is not and has not been an investor in any funds managed by Elliott Investment Management L.P.*

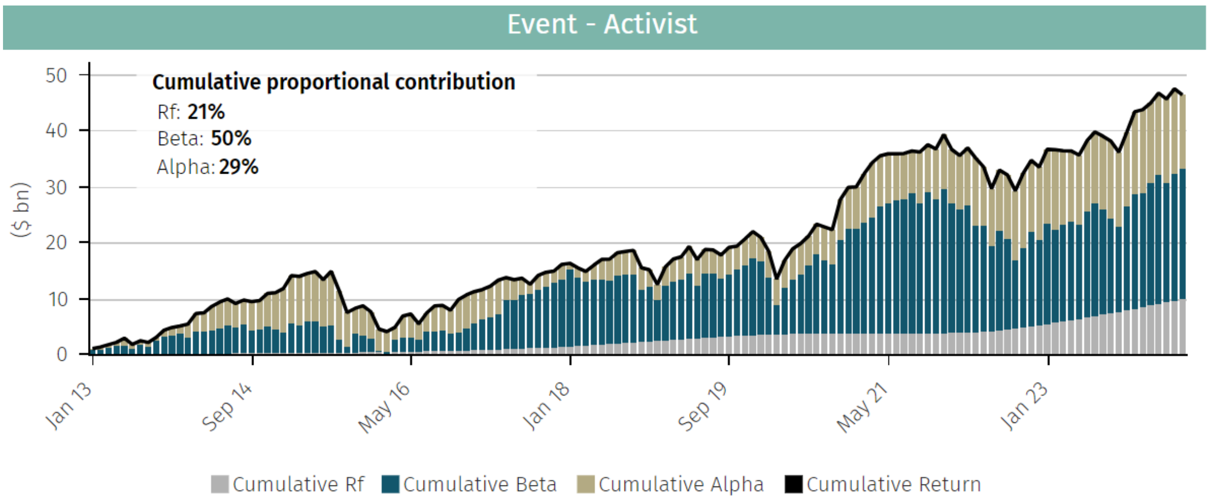
RISK/RETURN PROFILE

Risk and return expectations for activist funds tend to be at the higher end of both event driven strategies and broader hedge fund strategies. Key characteristics include:

- Long-biased: The strategy is typically long-biased in nature, resulting in activist funds historically exhibiting relatively high correlation to equity markets.
- Concentrated positions: Activist funds often manage a concentrated portfolio of high-conviction positions. The large equity stakes required to effect change in target companies typically results in fewer holdings, leading to less diversification. This concentration can result in higher volatility as the performance of a few key holdings can have a significant impact on overall fund returns.
- Long-term investment horizon: It is not uncommon for holding periods to span multiple years as realising value from positions often takes time. This long-term investment horizon can expose activist funds to prolonged market and company-specific risks, making the strategy susceptible to higher short- to medium-term volatility and larger drawdowns.
- Value-oriented: The strategy tends to be biased towards value-oriented investments. This value bias means that the strategy can underperform during periods when value is out of favour, such as the decade following the Global Financial Crisis when growth stocks significantly outperformed value stocks.
- Headline risk: Activist funds are prone to headline risk, where negative media coverage or public scrutiny of their activities can impact the perception and performance of their investments. This risk can lead to increased volatility and potential drawdowns, as market sentiment can swiftly turn in response to unfavourable news.
- Crowding: Activist funds often share a similar investment universe, leading to the potential crowding of positions. This overlap can exacerbate the aforementioned risk and result in increased volatility in stocks that attract multiple activist investors.

In summary, while the activist strategy has the potential to achieve substantial returns by driving significant changes in target companies, the combination of directional equity exposure, concentrated portfolios, long holding periods, and a value-oriented bias can result in the strategy being susceptible to higher volatility and larger drawdowns. Lastly, owing to the long-biased nature of the strategy, activist funds have historically exhibited a material proportion of returns attributable to beta rather than alpha generation.

ACTIVIST STRATEGY: DECOMPOSING DOLLAR PERFORMANCE INTO ALPHA, BETA AND RISK FREE (RF) COMPONENTS



*Source: Aurum Hedge Fund Data Engine, Bloomberg. These charts decompose the Hedge Fund Composite dollar returns into Beta, Alpha and Risk free ("Rf") components, as follows: Alpha = Actual return – Rf – Beta * (Market return – Rf).*

Where Rf is the Risk-free rate as defined by a rolling 3-month LIBOR-SOFR, where market return is that of S&P Global BMI ('the market index') and where Beta has been calculated with respect to each underlying fund observed on a 60m rolling basis to the market index. The monthly Alpha, Beta and Rf components are then applied to each underlying fund's dollar performance for a particular month, and then at a master strategy or industry level the individual fund dollar contributions are aggregated.

Merger arbitrage

DESCRIPTION

Merger arbitrage hedge funds specialise in capitalising on the price differential between the current market price of a target company's shares and the agreed-upon acquisition price in a merger or acquisition (M&A) deal. The strategy typically involves purchasing shares of the target company following an acquisition announcement and selling them once the deal is completed, thereby capturing the spread between the two prices. This spread reflects the market assessment of the perceived risk and timing of the deal closing, providing arbitrageurs with an opportunity to profit from the completion of the transaction. Key factors affecting this spread include:

- Risk of deal completion: The spread compensates for the possibility that the deal may not be completed as planned. Factors such as regulatory approvals, shareholder votes, and antitrust issues can influence this risk. The higher the perceived risk, the wider the spread.

- Time value of money: Since merger arbitrage involves waiting for the deal to close, the spread includes a premium for the time value of money. The longer the expected duration until deal completion, the wider the spread to compensate for the opportunity cost of capital being tied up. Prevailing interest rates can significantly impact this aspect.

- Market sentiment and volatility: Market conditions and sentiment towards the specific deal or the broader market can impact the spread. Increased market volatility or negative sentiment towards the deal can widen the spread due to heightened uncertainty.

- Competitive bids and deal revisions: The possibility of competing bids or revisions to the deal terms can affect the spread. If there is speculation that another company might offer a higher bid, the target's stock price may rise, narrowing the spread, or even exceed the initial bid price with the spread then referred to as 'trading through the terms'.

- Arbitrageur demand and market composition: Once a deal is announced, the composition of buyers and sellers in the target's stock shifts significantly. Arbitrageurs become the predominant traders, while 'real money' investors tend to avoid these situations. This change in market participants leads to a high sensitivity of the stock price to changes in supply and demand by arbitrageurs. When many merger arbitrage managers target the same stock, high demand for the target's shares can narrow the spread, whereas lower interest can widen it. The marginal buyers and sellers, primarily arbitrageurs, thus have a significant impact on the price dynamics post-announcement.

The method of financing a merger or acquisition — whether through cash, stock, or a combination of both — determines how merger arbitrage funds structure their trades. In deals financed entirely with cash, merger arbitrage managers typically take a long position in the target company's stock, purchasing shares at the current market price in anticipation that the acquisition will close at the higher agreed-upon cash price, thereby capturing the spread as profit. In stock-for-stock deals, where the acquisition is financed with the acquirer's stock, merger arbitrage funds take a long position in the target company's stock and also establish a corresponding short position in the acquirer's stock. This short position hedges against fluctuations in the acquirer's share price, which can affect the value of the deal. By shorting the acquirer's stock, arbitrageurs aim to lock in the value of the spread based on the exchange ratio stipulated in the acquisition agreement.

Historically, merger arbitrage was a strategy primarily employed by proprietary trading desks at large financial institutions. However, with regulatory changes, notably the Volcker Rule, which curtailed proprietary trading activities, hedge funds have become the primary practitioners of the strategy, operating either as a standalone merger arbitrage fund or as a sub-strategy within a broader event-driven or multi-strategy fund. Geographically, merger arbitrage funds tend to focus predominantly on the US market, or globally with a significant US tilt, due to the high volume of M&A activity, transparent regulatory environment and high liquidity. While some managers specialise in European markets, there are relatively few merger arbitrage funds focused on Asia.

Given the well-established and formulaic nature of the strategy, merger arbitrage has increasingly been implemented using quantitative, rules-based frameworks. These frameworks identify and participate in deals based on predefined characteristics such as: deal size, acquirer rationale, market capitalisation, geography and sector. Consequently, the strategy has been viewed as somewhat commoditised over time, with the return available often considered an alternative risk premium that is best captured systematically. However, despite the trend towards systematising the strategy, merger arbitrage remains largely discretionary. The complexities of assessing unique deal characteristics such as company synergies or antitrust risks, typically requires discretionary judgement and expertise.

SAMPLE TRADE

A recent high-profile merger arbitrage trade related to the acquisition of Activision Blizzard by Microsoft. In January 2022, Microsoft announced its proposal to acquire the video game giant for $68.7 billion, making it one of the largest deals in the tech industry. Microsoft agreed to pay $95 per share for Activision Blizzard in a fully cash-financed structure. The acquisition aimed to bolster Microsoft's gaming portfolio and solidify its presence in the rapidly growing gaming sector.

- Merger arbitrage funds reportedly purchased shares of Activision Blizzard at the prevailing market price, which was below the agreed acquisition price of $95 per share. The goal was to profit from the spread between the market price and the acquisition price, assuming the deal would go through.

- The transaction faced intense regulatory scrutiny from antitrust authorities in the US, European Union, and UK, with concerns about potential impacts on competition in the gaming industry. This regulatory uncertainty led to fluctuations in Activision Blizzard's stock price.

- Arbitrageurs closely monitored the regulatory approval process, market reactions, and legal challenges. The uncertainty and associated volatility in Activision Blizzard’s stock price provided opportunities for arbitrage profits.

- Despite initial regulatory hurdles, the deal received approval from various authorities and was completed in October 2023.

The trade example highlights the intricacies of merger arbitrage, particularly in navigating regulatory risks and continuously assessing the probability of deal completion in a highly scrutinised industry.

PERFORMANCE IN DIFFERENT MARKETS

Merger arbitrage is one of the most enduring of hedge fund sub-strategies. There are some specialists that have successfully operated merger arbitrage funds for over 30 years, such is the persistent nature of the phenomena that the strategy seeks to monetise.

As a strategy reliant on the completion of corporate deals, the performance of merger arbitrage funds depends largely on their ability to accurately assess and manage the idiosyncratic risks associated with individual deals, primarily the probability of completion and the potential for delays or deal breaks. However, the opportunity set for the strategy is broadly influenced by the level of M&A activity. Merger arbitrage funds thrive in environments with high M&A volumes as the number of deals not only increases the number of opportunities to deploy capital but also allows for better portfolio diversification, potentially reducing the impact of any single deal's failure on the overall portfolio. Conversely, the strategy can face challenges during economic downturns or when external shocks disrupt the M&A landscape. Fewer deals result in fewer opportunities for arbitrage, leading to increased crowding within existing deals and potentially compressing spreads.

The prevailing level of interest rates also plays an interesting dynamic in the performance of the strategy. Higher interest rates lead to increased borrowing costs for companies, making it more expensive to finance transactions and typically resulting in reduced M&A activity. However, higher interest rates also contribute to wider spreads, as investors typically demand a higher risk premium over the risk-free rate to compensate for the increased opportunity cost of capital and higher perceived risk. Conversely, a low interest rate environment typically encourages M&A activity but is accompanied by tighter spreads due to the lower required premium over the risk-free rate. As a result, the net effect of interest rates on the strategy's performance is multifaceted, influenced by a balance between the volume of M&A activity and the spread levels.

Finally, increased regulatory and political scrutiny can present a challenging environment for the strategy. Antitrust concerns are particularly impactful, as regulatory bodies like the Federal Trade Commission (FTC) in the US, the Competition and Markets Authority (CMA) in the UK, and the European Commission have become more aggressive in reviewing and potentially blocking mergers that they perceive to reduce competition or harm consumers. This increased scrutiny can lead to longer approval processes, higher chances of deal breaks, and wider spreads to compensate for the higher risk. Geopolitical factors can further complicate the environment, as shifts in trade policies, tariffs, and economic sanctions between countries can affect the feasibility and attractiveness of cross-border deals. This has been particularly prevalent between the US and China, with heightened scrutiny from regulatory bodies leading to the blocking or challenging of several high-profile deals in recent years (Xilinx/AMD in 2022, Qualcomm/Broadcom in 2018).

RISK/RETURN PROFILE

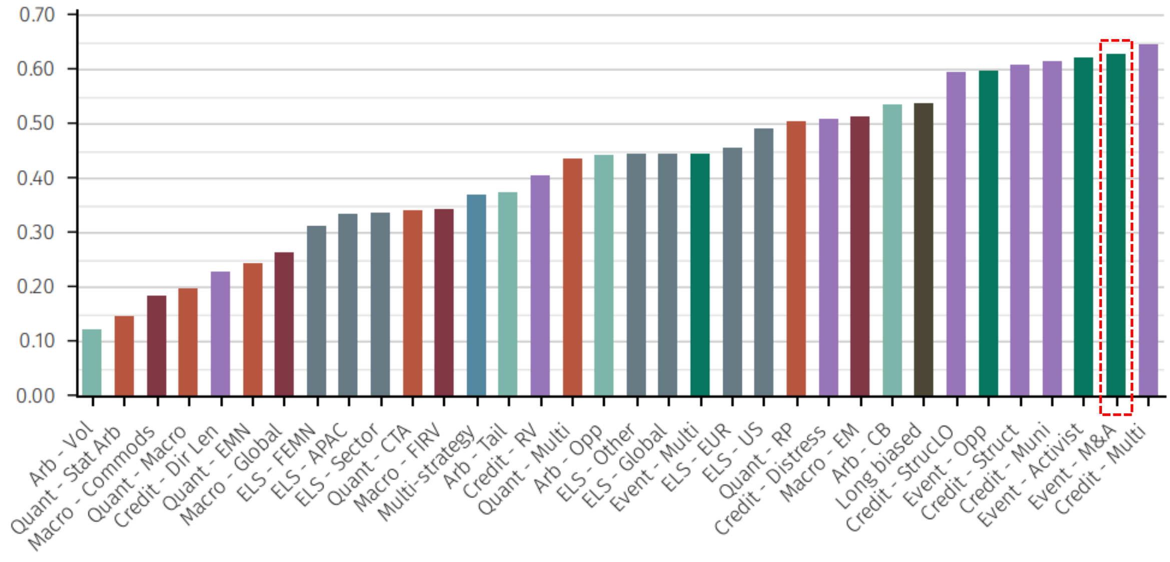
The risk and return characteristics of merger arbitrage are primarily driven by the outcomes of individual M&A deals rather than broader market movements. Accordingly, the strategy is generally considered to be market-neutral, despite the structure of underlying trades often being long-biased – particularly in cash deals where the position involves being long the target company without a corresponding short leg. As a result, merger arbitrage can remain uncorrelated with periods of acute market volatility or downturns, as the strategy's performance is more closely linked to M&A outcomes than market movements. However, extreme market sell-offs and heightened volatility can materially impact the strategy, as the viability and completion of certain deals may be jeopardised, and mark-to-market spread moves can become large enough to necessitate further de-risking, which can exacerbate losses.

Compared to activist funds, merger arbitrage funds tend to have more conservative return targets but generally experience lower volatility and less severe drawdowns. This can result in better risk-adjusted performance. As with many arbitrage strategies, merger arbitrage can exhibit an asymmetric return profile to the downside, as small, consistent returns from deal completions are pursued at the risk of large potential losses during adverse events, such as deal breaks or regulatory interventions. This asymmetry gives rise to the importance of deal selection and position sizing, to ensure the portfolio remains diversified and to mitigate the impact of any individual deal failure on overall performance.

Crowding is also an important risk factor for the strategy. Given the clearly defined universe of deals, merger arbitrage funds often share a similar investment universe which can lead to crowded positions and common factor risk. In adverse deal scenarios, the simultaneous liquidation by multiple funds can amplify selling pressure and exacerbate losses. Furthermore, the proliferation of the strategy being deployed within pod structures of multi-strategy funds, operating under tighter risk management frameworks, has made forced liquidations more prevalent. These risk-reducing actions, necessary for managing overall portfolio volatility, can result in substantial spread volatility during pod liquidations.

The clearly defined investment universe of deals also leads to a high degree of homogeneity across merger arbitrage funds, with intra-strategy correlations among the highest relative to other hedge fund strategies:

AVERAGE INTRA-STRATEGY CORRELATION (5 YR)[1] – SUB-STRATEGY



Source: Aurum Hedge Fund Data Engine, data to 30 June 2024. [1] Equally weighted returns

Managers can differentiate themselves from their peers in several ways. Some are more willing to actively trade around deals and event milestones, such as regulatory approval announcements, shareholder voting outcomes or other milestones that may impact deal completion. Others focus on more complex or obscure jurisdictions, navigating unique regulatory and market environments to find opportunities overlooked by competitors. Additionally, some managers are willing to short deal positions, a less common practice in merger arbitrage due to the historically high closure rates of announced deals. However, shorting can be an attractive characteristic, offering asymmetry to the upside and providing a hedge against deal failures or broader spread widening.

Event – multi-strategy

DESCRIPTION

Event – multi-strategy funds are characterised by their diversified approach to investing across multiple event driven sub-strategies. While activism and merger arbitrage are well-defined components within this spectrum, these funds typically allocate across multiple event-oriented sub-strategies, most notably merger arbitrage, event driven credit, and special situations. The latter is a broad category encompassing diverse, less tangible catalyst events that are typically focused on companies undergoing significant changes in either corporate structure or capital structure. Additionally, special situations can often include more arbitrage-oriented strategies such as share class arbitrage, dual-listed arbitrage, capital structure arbitrage, and holding company/stub arbitrage. Event – multi-strategy funds may also deploy liquidity provision strategies, including index rebalancing and equity capital market (ECM) strategies.

Event – multi-strategy funds are typically structured with multiple PMs or PM teams/'pods', each focusing on a distinct event driven sub-strategy. Whilst capital allocations across each strategy area can be dynamic depending on the prevailing opportunity set, they typically change less frequently or dramatically than funds characterised in the event – opportunistic bucket (see below).

STRATEGIES DEPLOYED

Event – multi-strategy hedge funds invest across a number of event-driven sub-strategies. In addition to merger arbitrage and activism already detailed in this primer, other strategies include:

EVENT DRIVEN CREDIT

Strategies focusing on exploiting opportunities that arise from specific credit-related catalyst events, often in stressed or technical credit situations. Positions are typically centred on balance sheet repair events such as bond refinancing events, clauses in bond indentures, recapitalisations (equity issuance, debt-for-equity swaps), and restructuring events (divestitures), as well as catalyst-driven upgrades or downgrades to credit ratings.

SPECIAL SITUATIONS

Strategies encompassing a diverse range of trade types focusing on companies undergoing significant changes in either corporate structure (spin-offs, asset sales/divestitures, management changes) or capital structure (rights issues, special dividends, share buybacks). These situations are typically complex and require a deep understanding of the specific event and its potential impact on the company's future.

SHARE CLASS ARBITRAGE

Capitalising on price discrepancies between different share classes issued by the same company. Companies can issue different share classes to retain control (e.g., non-voting shares alongside common shares), cater to investor preferences (e.g., non-voting shares with higher dividends), or address regulatory and tax considerations. These share classes can trade at different prices due to their unique characteristics and/or temporary supply-demand imbalances, with price convergence typically occurring around corporate events. A key risk to the strategy is the potential for prolonged dislocation or further divergence in share prices, given the non-fungible nature of different classes, especially in the absence of a clear catalyst for convergence.

DUAL-LISTED ARBITRAGE

Capitalising on price discrepancies between shares of the same company listed on different stock exchanges. These discrepancies can arise due to differences in supply and demand, currency fluctuations, market sentiment and transaction costs between the two markets. The execution of the different legs of the trade across different time zones is often not simultaneous, introducing 'legging risk', where the market price of one or more of the desired legs can become unfavourable during the time it takes to complete the various orders.

CAPITAL STRUCTURE ARBITRAGE

Capitalising on price discrepancies in the valuation of different securities within a company's capital structure, across both debt and equity. The strategy targets situations where the market prices of these securities are deemed to be mispriced with their relative risk and return profiles. Price convergence typically occurs around corporate events such as debt restructurings, equity offerings, or credit rating changes, which can realign the valuations of the company's securities.

HOLDING COMPANY/STUB ARBITRAGE

Capitalising on price discrepancies between the market value of a holding company and the combined value of its underlying subsidiaries. The strategy typically focuses on 'stub' values - the portion of the holding company's valuation not accounted for by its listed assets - targeting situations where the stub's implied market value is seen as mispriced. This is often indicated by the holding company's stock trading at a discount to the sum of its parts. Price convergence typically occurs around corporate events such as upcoming spin-offs, asset sales or divestitures, which may unlock value in the stub or realign the valuation.

INDEX REBALANCING

The strategy aims to exploit predictable price movements of stocks added to, removed from, or adjusted within major stock indices such as the S&P 500, FTSE 100 or Russell 2000. Index providers periodically update their constituents based on criteria such as market capitalisation, liquidity, and sector representation. The strategy involves anticipating the buying and selling pressures induced by passive investors, such as index funds, that adjust their portfolios to mirror changes in the index composition. Stocks added to or upweighted in an index typically see price increases due to the increased demand, while stocks removed from or down-weighted often see price declines due to expected sell-offs. The strategy requires precise timing and execution to manage the risks associated with market impact, factor risks (particularly momentum) and crowdedness, as hedge funds themselves can become the marginal buyers of the targeted stocks, potentially diminishing the effectiveness of the strategy.

EQUITY CAPITAL MARKETS (ECM)

Strategies focusing on opportunities created by equity capital markets (ECM) activities such as initial public offerings (IPOs), follow-on offerings, and block trades. These events can create short-term price movements and inefficiencies, providing opportunities for hedge funds to generate alpha. Strong capital markets relationships are crucial for accessing IPO allocations, participating in secondary offerings, and engaging in block trades, where a large number of shares are sold off-market at a discount. Additionally, some funds aim to short stocks in anticipation of secondary offerings or block trades, aiming to cover the position after the price drops due to equity dilution or a temporary position overhang.

PERFORMANCE IN DIFFERENT MARKETS

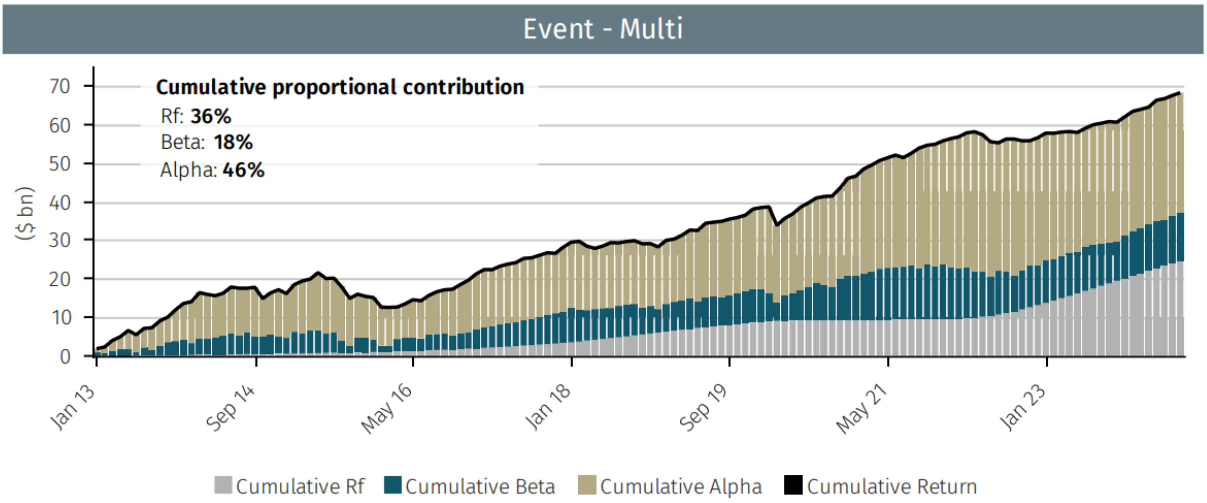
By allocating capital across multiple event driven strategies, event - multi-strategy funds aim to deliver diversified returns with relatively low volatility across various market environments. Many of the underlying sub-strategies, particularly those focused on liquidity provision, can be highly cyclical in nature. They have the potential to generate strong, uncorrelated returns when market conditions are favourable, but may struggle to generate alpha during benign periods (such as when there is a lack of deal flow in ECM, or outside of the major index rebalancing windows).

In addition, special situations and event arbitrage-oriented sub-strategies tend to be highly opportunistic in nature. These strategies typically aim to capitalise on fleeting opportunities, and the investment universe for potential trades within dual-listed arbitrage, share-class arbitrage, and holding company/stub arbitrage has diminished in recent years due to an increase in companies taking steps to simplify their capital structures. As a result, the broad coverage of event – multi-strategy funds is designed to capitalise on a diverse array of event driven situations, somewhat mitigating the impact of the cyclicality and opportunistic nature of individual strategies.

RISK/RETURN PROFILE

Event – multi-strategy funds tend to offer modest yet consistent returns with low volatility, due to their diversified approach across multiple event driven sub-strategies. The differentiation among funds within this category is typically determined by their selection and weighting of the event driven sub-strategies, the amount of leverage used, and their tolerance for beta exposure to broader equity markets. That said, the risk/return profile of these funds is primarily driven by their ability to generate alpha from idiosyncratic events. Accordingly, a significant proportion of the returns from event - multi-strategy funds has been attributable to alpha rather than beta.

EVENT – MULTI-STRATEGY: DECOMPOSING DOLLAR PERFORMANCE INTO ALPHA, BETA AND RISK FREE (RF) COMPONENTS



*Source: Aurum Hedge Fund Data Engine, Bloomberg. These charts decompose the Hedge Fund Composite dollar returns into Beta, Alpha and Risk free ("Rf") components, as follows: Alpha = Actual return – Rf – Beta * (Market return – Rf).*

Where Rf is the Risk-free rate as defined by a rolling 3-month LIBOR-SOFR, where market return is that of S&P Global BMI ('the market index') and where Beta has been calculated with respect to each underlying fund observed on a 60m rolling basis to the market index. The monthly Alpha, Beta and Rf components are then applied to each underlying fund's dollar performance for a particular month, and then at a master strategy or industry level the individual fund dollar contributions are aggregated.

Event – opportunistic

DESCRIPTION

Event – opportunistic hedge funds share similarities with the event – multi-strategy classification but are distinguished by their highly flexible and opportunistic approach. These funds will more dynamically adjust their capital allocation across multiple event driven strategies, and may concentrate a significant portion — or even all — of their risk in a specific area, including event driven credit, equity capital markets or index rebalancing, based on the prevailing opportunity set. The approach differs to event – multi-strategy funds that typically remain allocated across multiple sub-strategies at all times, with changes occurring less frequently or dramatically than event – opportunistic funds.

These funds are typically, though not exclusively, managed by a single CIO or PM who engages in the various strategies as opportunities arise. The defining characteristic of these funds is their ability to move capital swiftly to areas with the best opportunities while underweighting or avoiding strategies that are less favourable.

PERFORMANCE IN DIFFERENT MARKETS

Event – opportunistic hedge funds, like event - multi-strategy funds, aim to deliver diversified returns across various market environments. However, there are some distinctions in their performance characteristics due to their more flexible and concentrated approach.

By dynamically adjusting capital across multiple event driven strategies, event - opportunistic funds seek to capitalise on the best opportunities available at any given time. This flexibility allows them to potentially generate stronger returns relative to event – multi-strategy funds, especially when market conditions favour a particular sub-strategy that has been overweighted. For instance, these funds may concentrate their risk in event driven credit during post-crisis periods, or in ECM during periods of significant capital markets activity, aiming to fully take advantage and maximise returns from these opportunities.

RISK/RETURN PROFILE

Event - opportunistic hedge funds tend to offer the potential for higher returns with moderate to high volatility, due to their highly flexible and sometimes concentrated approach to particular event driven strategies. Consequently, Sharpe ratios for these funds can vary significantly, , depending on the prevailing market conditions and the fund's ability to capitalise on specific opportunities. However, due to the greater tolerance for strategy concentration, these funds may experience periods of heightened volatility and larger potential drawdowns in the event that situations do not perform as expected. This results in a more variable risk/return profile compared to event - multi-strategy funds, reflecting their opportunistic nature and dynamic strategy adjustments.

AURUM

Aurum Fund Management Ltd.

Aurum House
35 Richmond Road
Hamilton HM08
Bermuda
Telephone: +1 441 292 6952

Website: www.aurum.com
Email: ir@aurumfunds.com

Aurum Funds Limited

Ixworth House
37 Ixworth Place
London
SW3 3QH
Telephone: +44 (0)20 7589 1130

Waystone Investment Management (IE) Limited

4th Floor, Shelbourne Road,
Ballsbridge
Dublin D04 A4E0, Ireland

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