The Merger Fund® - July Market Commentary

Dear Investors,

Given recent volatilty in the merger arbitrage market over the past several weeks, we would like to share some perspectives.

Willis Towers Watson/Aon

On July 26th, insurance brokers Willis Towers Watson and Aon agreed to terminate their $30 billion merger agreement and end litigation with the U.S. Department of Justice.

The deal was struck in March 2020 and, shortly thereafter, both parties agreed to certain divestitures in connection with investigations by a variety of international regulatory agencies to resolve competition concerns.

Upon deal announcement, we analyzed the merger contract, engaged multiple antitrust counsel and industry consultants, and as a result, we forecast that the transaction was likely to be completed.

At the end of June, the Justice Department sued to block the deal, stating that the proposed remedies were inadequate to protect United States consumers. After the lawsuit was filed, we continued to confer with counsel and consultants, and although the pending litigation increased uncertainty, we concluded that it remained more likely than not that the suit would either be settled prior to trial or that the parties would win at trial.

Prior to deal termination, WLTW/Aon had been one of the more widely held and larger positions in the event-driven community, given high levels of conviction in the deal and presumed limited downside.

As recently as last week, the deal was trading in the market at an approximately 30% implied likelihood of success, which we thought was significantly mispriced. Additionally, our calculated downside was approximately 6% of the value of the position. The jury is still out on what the "seasoned downside" is, but our initial downside estimate has proven to be (hopefully temporarily) incorrect. In other words, on the day of termination the arbitrage spread was $24.65 (the discount to the dollar value of the consideration paid to WLTW holders) and we had calculated that it would widen out to approximately $41on a break, but the surprise termination announcement, surprisingly announced during the early stages of litigation, caught many sophisticated investors wrong-footed and by mid-afternoon that same day, WLTW was trading at a $70 spread rather than the $41 we had estimated. To date, The Merger Fund has given back more than 100 basis points of performance due to the deal's termination.

We have seen stock prices overreact in the past to unexpected events and terminations such as this, and have found that it is suboptimal to immediately liquidate positions into the announcements. As usual, we intend to exit the position, in an orderly manner, as market conditions allow, and we remain directionally hedged in the interim.

“Sympathy” Spread Widening

Given the widespread exposure to Willis Towers , it is not suprising that we have seen “sympathetic” spread widening in other existing deals which require regulatory approval. Arbitrageurs’ risk management policies often require across-the-board exposure reduction as investors and deal principals reassess transaction risks.

Although market movements are ultimately irrelevant to merger arbitrage investments (as long as the deal is completed), in times of uncertainty, arbitrage and event spreads typically widen to reflect additional return that investors require in order to incur a perceived increase in risk. This often causes the securities to trade inefficiently, at prices which do not accurately reflect unchanged likelihoods of transaction completion. These instances are often attractive opportunities to add exposure at discounted prices.

China-U.S. Tensions

Reciprocal scrutiny over corporate acquisitions has also intensified amid China-U.S. tensions, particularly in the technology sector. This has led to increased regulatory uncertainty, particularly on the part of China’s oversight agency, called SAMR (State Administration for Market Regulation). Accordingly, spreads have widened significantly among deals that require Chinese approval. However, our view, based upon years of observation, is that innocuous transactions should still receive approval even though the process has become significantly more politicized. We are more cautious on the more sensitive technology acquisitions.

We have experienced similar periods of “risk-off” sentiment, and our optimism for transaction volume and closing likelihoods remains. We will continue to focus on deal selection and risk assessment, and we will unwind positions where we deem the risk/reward profile to have deteriorated.

The bottom line remains that irrespective of equity market movements, for those transactions that proceed to closure, their spreads will tighten to zero, and the negative marks-to-market on those positions will be reversed.

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advisor. Messrs. Behren and Shannon, the Fund's current portfolio managers, have served as co-portfolio managers of the Fund since 2007.

Mutual fund investing involves risk. Principal loss is possible. Merger-arbitrage and event-driven investing involves the risk that the adviser's evaluation of the outcome of a proposed event, whether it be a merger, reorganization, regulatory issue or other event, will prove incorrect and that the Fund's return on the investment will be negative. Investments in foreign companies may entail political, cultural, regulatory, legal, and tax risks different from those associated with comparable transactions in the United States. The frequency of the Fund's transactions will vary from year to year, though merger arbitrage portfolios typically have higher turnover rates than portfolios of typical long-only funds. Increased portfolio turnover may result in higher brokerage commissions, dealer mark-ups and other transaction costs. The higher costs associated with increased portfolio turnover may offset gains in the Fund's performance. The Fund may enter into short sale transactions for, among other reasons, purposes of protecting against a decline in the market value of the acquiring company's shares prior to the acquisition completion. If the price of a security sold short increases between the time of the short sale and the time the Fund covers its short position, the Fund will incur a loss. The amount of a potential loss on an uncovered short sale transaction is theoretically unlimited. Debt securities may fluctuate in value due to, among other things, changes in interest rates, general economic conditions, industry fundamentals, market sentiment and the financial condition of the issuer, including the issuer's credit rating or financial performance. Derivatives may create leverage which will amplify the effect of the performance of those instruments on the Fund and may produce significant losses. The Fund's hedging strategy will be subject to the Fund's investment adviser's ability to assess correctly the degree of correlation between the performance of the instruments used in the hedging strategy and the performance of the investments in the portfolio being hedged.

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