Hello,

On behalf of Harris Arch, CFA and Dan Moore, CFA, the portfolio managers of DuPont Capital's merger arbitrage strategy, attached is our monthly commentary and the January 2022 fact sheet containing performance and risk metrics.

Performance

For the month of January, our Merger Arbitrage strategy decreased 67 basis points (bps) net of fees and the Merger Arbitrage Enhanced strategy, which utilizes leverage, decreased 172 bps net of fees. The Merger Arbitrage Enhanced strategy is conservatively leveraged at 1.85X gross and 1.75X net leverage.

Outlook and Strategy

In merger arbitrage, there was modest spread widening during January. In the equity markets, the S&P 500 declined 5.26%, while the Nasdaq dropped 8.98%. We rarely highlight the performance of traditional equity indices in our commentary since our portfolio has a low correlation and alternative strategies should function as “alternatives” to equities and fixed income, but it is worth noting that for pending M&A deals, the target’s standalone value usually declines during substantial market corrections. If a pending merger arbitrage has a 95% breakeven probability, when the target value declines, then the spread will widen even if the breakeven probability remains unchanged to incorporate higher downside. If the deal ultimately closes, then the loss from spread widening is temporary and will reverse. Of course, if the buyer tries to abandon the deal, then that loss would become permanent. We remain very vigilant in assessing likelihood of deal closings and note that recent market fluctuations are certainly not a material adverse clause situation. This is not a scenario like March 2020 when Covid-19 first emerged and buyers tried to abandon deals as the economy shut down. Market corrections are to be expected and that risk is often contractually borne by the buyer in a merger deal.

During January, there were a few notable M&A deals that merit further discussion. Microsoft announced the acquisition of Activision for $68 billion, which would be Microsoft’s largest deal ever. This deal faces significant regulatory scrutiny, as mega-cap tech is in the regulator’s crosshairs, although we believe that Amazon, Alphabet, and Meta are higher up on the focus list given their platform business model. The deal is a classic vertical deal in that Microsoft has video game “hardware”, Xbox, while Activision provides a wealth of video game titles (“software”). Under a more benign antitrust environment a few years ago, we believe this deal would have ultimately received approval with behavioral remedies that allowed competing hardware companies access to Activision’s games so that Microsoft would not be the exclusive provider.

Shortly after the deal was announced, senior Microsoft executives went to D.C. to start their charm offensive and have already made public that they would allow Activision's game, Call of Duty, to be available on competing platforms beyond the current contractual period. This deal faces a long timeline to close, most likely Q1 2023, and is pricing in roughly 50% breakeven probability of approval, which reflects merger arbitrage skittishness on an evolving regulatory policy.

Another notable deal during the month was Elliot Management and Vista Equity's acquisition of Citrix Systems for $14 billion, which is one of the largest technology leveraged buyouts in history. This deal will be an important test case for the health of the credit markets. Recently, certain issuers have shifted high yield debt issuance to loans as the loan market has become more receptive. Credit investors have preferred the floating interest rate provided by loans, which typically fare better in a rising rate environment. Year to date, the leveraged loan market performance has held up much better than high yield. We are keenly watching the health of the loan and high yield markets, as this will be a key funding source for future M&A, especially among private equity buyers. When managing this strategy during early 2016, we witnessed the loan markets seize up due to China led macro growth concerns, yet pending M&A deals closed. Merger documents are often not conditional on financing, meaning the acquirer is still on the hook for the deal, even if financing becomes more troublesome. Often, financing to acquirers is contractually committed by investment banks in the form of bridge financing. If the markets seize up, the banks will retain the debt on their balance sheet until the market thaws and they can syndicate the debt, which occurred in 2016.

Given the long duration of certain pending deals and increased equity market volatility to the downside, we are being patient in establishing positions. We are aware that certain systematic merger arbitrage strategies often buy on the first day of an announced deal and that may keep the spread tighter than warranted, so sometimes it can be more advantageous to wait. Taking a step back to consider deal flow, it is important to consider that private equity still has substantial dry powder, which will fuel further M&A. Large corporates are most likely waiting to see more evidence of the evolving antitrust regulatory environment before embarking on meaningful deals. We believe that even if there are certain near-term hiccups in the number of M&A deals, there will still be an adequate opportunity set to consider.

Turning to SPACs, the decline in the value of warrants since December has continued to modestly detract from our performance. We are very mindful of our warrant exposure, which remains in the low single digit percentage of our overall holdings. The environment for SPAC targets has become more challenged in the past few months due to the rise in interest rates. Most notably, unprofitable technology companies, which are the prime fishing pond for SPAC targets, have been hit hardest in the recent value rotation.

Currently, many SPACs are facing high redemption levels, which is not surprising given that before the vote, they are trading below cash trust value. In Q4 2020 and Q1 2021, the redemption rates were far lower simply because it was rational for arbitrages to sell in the open market when trading above trust value rather than elect to redeem. The high redemption rates have debunked certain purported benefits of the SPAC structure as an alternative to the traditional IPO. SPAC sponsors often touted that they provide the target with certainty of funds and valuation, compared to an IPO where the valuation is not established until the book building process nears its end and the deal is finally ready to price. More recently, several SPAC deals have seen the valuation recut to preserve cash in trust and discourage redemptions. This also calls into question the acumen of the sponsors when their deals are recut at meaningful levels only a few quarters after inking a deal. Also, given the wave of redemptions, the amount of capital raised during the IPO may be far less than envisioned. Often, deals include a minimum cash condition and because of the high level of redemptions, several deals have recently terminated as they have missed the minimum cash level.

Despite the recent doom and gloom hanging over the SPAC market, we believe that most of this pessimism is already reflected in the price. As mentioned in previous commentaries, the terms to lure investors back into the SPAC new issue market have improved. Management teams are often overfunding the trust by 15-25 cents, increasing warrant coverage to ½ warrant, and shortening duration to 15-18 months. Even with the better terms, many new issues hover at the $10.00 IPO price on day 1. If issuers try to tighten terms and day 1 prices start to drop below $10.00, investors will simply stop showing up, as they have in the past. Given the improvement in terms and the selloff in previously issued SPACs, many are currently trading at nearly 3% yield to maturity. If and when rates increase, the cash in trust, which is typically invested in 6-month treasury bills, will reflect higher rates. SPACs are similar to very short duration fixed income and will benefit from higher rates, whereas longer duration, traditional fixed income will be adversely affected by higher rates.

One area we are keenly following in SPACs is potential regulatory from the SEC, headed by new chair Gary Gensler. Over the past year, his public comments regarding SPACs are often focused on disclosure such as how the sponsor is compensated and ensuring that management forecasts are on a level playing field with traditional IPOs to avoid any so-called "regulatory arbitrage." Given the comments so far, we think the mechanics of SPACs will be unchanged and any reform will focus on disclosure.

That past several months have certainly been challenging in the merger arbitrage and SPAC space, dating back to the Aon/Willis break last summer. During times like this, it is critical to constantly question our approach and analysis. In merger arbitrage, given the heightened regulatory risks, we are being nimble in establishing positions and remain diversified to avoid deal breaks that could "come out of left field." This often means that we avoid certain binary deals with lower breakeven probabilities involving a difficult regulatory process, particularly in sensitive industries. In SPACs, we have always approached the space from an arbitrage perspective. If at the time of redemption, the security is below trust, we will elect to redeem and receive our initial investment back. Given the improvement in yields to nearly 3%, that provides attractive downside protection for redemption.

If you would like to speak to us in more detail, please reach out and we would be happy to provide more detail on our strategy.

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Please see GIPS Report in attached Fact Sheet.