DuPont Capital

EQUITY STRATEGY REVIEW
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Merger Arbitrage

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While the S&P 500 declined 4.08% during the month of August, we are pleased to report positive performance in our merger arbitrage portfolios. Though it is prudent to avoid excessively focusing on one particular month, this divergence in performance demonstrates the low correlation of our strategy to the broader capital markets. The performance of our strategy ultimately depends on whether deals in the portfolio successfully close rather than the attractiveness of any singular market attribute such as value or growth, small or large cap, US or international, etc.

In August, we benefitted from the approval from CMA, the UK regulator, in the Avast/NortonLifeLock deal. The arbitrage spread had widened materially as the deal unexpectedly advanced to a Phase II review. In other jurisdictions, such as the US and European Union, the deal had already been approved. It was a surprise to the market that the deal was not approved in Phase I by the CMA. In Phase I, the regulator had taken a narrow definition of the antivirus software market that only included paid software and excluded major free or bundled offerings such as Microsoft Windows Defender. This analysis was contrary to the market definition used in other jurisdictions. While the deal languished in Phase II, the spread widened to over 40%. Our research indicated that the regulators might consider a broader market definition in Phase II, especially as Microsoft continued to accelerate its product offerings. When the deal was approved in early August, the arbitrage spread tightened significantly.

Being able to hold a position such as Avast through the interim decline is important. We are keenly aware of other levered merger arbitrage portfolios that often have to sell down in times of weakness or market drawdowns. The ability to accurately time the highs and lows of a particular deal is extremely difficult and if we believe a deal will ultimately close, we will often continue to hold the deal. As mentioned in previous monthly commentaries, sizing the position appropriately is important so that during a decline, the mark to market loss does not become too onerous.

In recent months, we have certainly witnessed a slowdown in M&A. One culprit has been the rising cost of debt financing. As we write this monthly commentary (late September), the financing for the Citrix acquisition by private equity is currently being marketed. Almost every day over the past week, there is a Bloomberg headline related to the widening discounts in the loans and bonds for the deal. While it is uncertain when M&A will substantially increase from here, it was noteworthy to see one key private equity head from Apollo throw cold water on the idea that the banks will open the lending spigot soon (https://www.bloomberg.com/news/articles/2022-09-14/apollo-s-sambur-sees-banks-on-sidelines-for-lbos-for-months).

In the market selloff following Jerome Powell's hawkish Fed comments at Jackson Hole and the higher-than-expected August CPI reading, we have selectively initiated positions in certain merger arb deals as the spread has widened. Often, market downturns provide an opportunity to add or initiate a position if the spread widens and we believe there is still a strong likelihood of deal closing.

About our firm:

DuPont Capital Management is an SEC registered investment advisor based in Wilmington, Delaware. Since the firm's establishment in 1993, we've had a long history of developing global investment opportunities in both traditional and alternative strategies across equity, fixed income and alternative investments. Our investment team structure gives us the ability to be flexible and adapt to changing market conditions. DuPont Capital's focus is delivering consistent investment management results for our clients. Our history of institutional asset management is rooted back to 1942 when our former parent company, DuPont, established a pension plan for its employees. Corteva Inc. succeeded DuPont as sponsor of the DuPont Pension Plan in 2019. DuPont Capital is a wholly owned subsidiary of Corteva and continues to manage the legacy DuPont Pension Plan.

DuPont Capital's President and CEO, Valerie Sill believes in education and diversity of experience as represented in our investment teams which are comprised of PhDs, engineers, medical doctors, and scientists. We believe their global expertise creates a portfolio implementation edge that benefits our clients.

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