DuPont Capital

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 December 2022 fact sheet containing performance and risk metrics.

Performance

For the month of December, our Merger Arbitrage strategy increased 49 bps net of fees and the Merger Arbitrage Enhanced strategy, which utilizes leverage, increased 60 bps net of fees. For the year, Merger Arbitrage is up 1.37% and Merger Arbitrage Enhanced is up 0.06%, net of fees. The Merger Arbitrage Enhanced strategy is minimally leveraged at 1.12X gross and 1.05X net leverage. In recent months, the leverage has declined as our SPAC holdings reach their redemption date. The present leverage ratio is near our lowest since the levered fund was started in 2020.

Outlook and Strategy

At the start of a new year, many sell-side market prognosticators publish grand predictions for the year ahead. We will review the past year and current trends but recognize that just because the calendar flipped to a new year does not mean the market must turn a new page. Some of the recent trends such as a slowdown in M&A activity could continue well into 2023. The slowdown in M&A has been caused by several factors that we have described in past commentaries, namely the decline in equity markets, rising interest rates, and fears of an impending recession. Management executives and boards are reluctant to pursue M&A when the path of the economy is highly uncertain. Furthermore, underwriters have had difficulty selling debt for private equity buyouts and have incurred substantial losses on previous deals. For M&A to pick up from here, we would need a capital markets recovery and improving economic indicators, which would induce merger participants to believe that tomorrow will be better than today.

The regulatory environment has become quite challenging over the past year. The FTC and DOJ have shown a strong willingness to litigate rather than accept remedies. It seems that recent court losses by the government such as US Sugar and Change Healthcare have not weakened their resolve. From an arbitrage perspective, the prospect of litigation may prevent buyers from pursuing M&A at all. Litigation is costly and time consuming. Furthermore, litigation will materially extend the time to close for a deal, which will lower the annualized rate of return. Arbitrage deals that might end up in court need to incorporate a wider spread at the outset of the deal to compensate for the litigation risk.

In spacs, we are marking the two-year deadline for most spacs that were issued during the peak in Q4 2020 and Q1 2021. In cases where a spac is liquidating, we are receiving our initial investment plus interest. Q4 2020 and Q1 2021 was a frothy period in the capital markets, driven by meme stocks and high valuations for loss making companies. In most cases, we were able to monetize gains in announced de-spacs that had rallied on this speculation by selling into the strength. Given the changes in market dynamics of higher interest rates, value style leadership, and legislation regarding spacs, it is unlikely that the Q4 2020-Q1 2021 environment will be repeated, but that frothy environment was not our base case when we started investing in spacs in 2019. In recent quarters, we have redeemed our holdings and are content to either redeploy that cash in corporate merger arb investments or build up our cash holdings.

Whenever we read a piece of investment research or outlook, we often rhetorically wonder, "What is the punchline?" If you have made it this far in our investment commentary, you may be wondering what are the investment implications in merger arbitrage for a slowdown in the number of deals. While there are fewer deals, as demonstrated in past slowdowns, there is always some baseline level of corporate activity. At troughs, some buyers seek to purse deals at a cheaper valuation, sometimes in a hostile fashion. In other cases, the seller encounters financial or operational difficulty and seeks a sale to improve their prospects. Despite fewer deals, we are not putting on deals in the portfolio for the sake of being invested. We are remaining patient for either new deals with more attractive spreads or spread widening in existing deals. Typically, the markets encounter a few periods of turbulence each year and spreads widen. For example, last fall, we were able to add or initiate in certain positions as the equity markets sold off due to recessionary fears and peaking long term interest rates.

Currently, there are certain pending deals that have very wide spreads and low implied probabilities of closure, but that is typically not our hunting ground in the portfolio. Those deals often feature significant regulatory risk and as mentioned earlier, the current antitrust regime is too opaque to make an educated guess or rely too heavily on past legal precedent. Deals that would have been approved a few years ago, with or without remedies, are simply ending up in court or terminated. Additionally, Chinese regulators remain a wildcard. An investor should generally assume that any deal requiring SAMR approval will take longer than expected, and that could cause the deal to break if it exceeds the termination date, as occurred recently in Rogers/DuPont.

The past year was one of survival and defense within our merger arbitrage portfolios. By currently building up our cash on hand, we preserve the optionality to pivot to offense when the opportunity presents itself.

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.