AQR Quick Clips

Still Dislocated? AQR's Arbitrage Outlook

The sharp deleveraging across arbitrage markets in March 2020 was followed by very strong performance in the second half of 2020. In our recent webinar, Todd Pulvino and Jeremy Getson reviewed what drove last year's returns in SPACs, convertibles and mergers, and discussed why we are optimistic about the outlook for 2021 and beyond.

What happened across arbitrage markets in 2020, and what's your outlook going forward?

Tactical dislocation opportunity in March to steady state opportunity in July.

Last March, we experienced a fundamental shock. Corporations immediately saw disruptions to their business models, their balance sheets became stressed and investors flocked to safety. This was a classic example of a liquidity void: Corporations needed capital and investors fled in another direction.

That said, as security prices fall and investors turn away, it tends to be a good time for arbitrageurs to deploy capital. In almost all arbitrage strategies, long and short positions are linked by a contract, which acts like rubber band. The band can stretch too much and break, but most of the time it reverts to its original size, as we saw in July. Let's take a look at what happened to the different types of arbitrage:

Convertible Arbitrage

What happened in 2020: We saw record issuance last year.[1] During the initial drawdown, convertibles cheapened dramatically, but those who put money to work at this point did very well as valuations rebounded. However, trading activity indicates that there was a dispersion within the convertible market even after the initial shock wore off. Non-arbitrageurs (long-only players) were purchasing convertibles based on their underlying security valuations, therefore allowing arbitrageurs ability to rotate out of rich bonds and into cheap ones, creating a price disparity.

Our outlook for 2021: We suspect issuance will remain strong, though maybe not at record levels, given the volatility in the underlying stock prices. This makes the embedded option in convertibles more attractive and encourages companies to issue them. In addition, convertibles present a convenient instrument to work out of, as you can induce holders to convert to equity early and extinguish their debt liability.

Merger Arbitrage Market

What happened in 2020: When you have a massive liquidity void like we saw in March, deal activity can be impacted. The merger rubber band is not as strong as its convertible counterpart during these events, and it can oxidize, get brittle and snap. Typically deals that go through compensate for the ones that break, but you're more likely to get adverse outcomes in merger arb than in other strategies.

Our outlook for 2021: Long term, and post crisis, companies and industries will have to restructure. In many cases they need to get their costs out or their revenues up. And we expect to see COVID-related restructurings continue. In addition, resolution around the U.S. election will lead companies to define their strategic plans, and this will lead to corporate restructurings (i.e. mergers and spinoffs).

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[1] Convertible Bond new issuance in 2020 as $114B vs. previous record of $106B in 2001. Source: AQR/CNH, BAML

Special Purpose Acquisition Companies (SPACs)

What happened in 2020: Last year was an unprecedented year in the SPAC market.[2] Like public companies, when COVID hit, private companies also needed to get access to capital. These private companies are typically growing, often with negative earnings but with very strong projections. A SPAC is a "blank check company," where a sponsor will raise money in a trust account invested in treasury bills, which is a public company that can then look for an asset to buy. When private operating companies/assets go public by merging with a SPAC, they get the capital they need to expand and invest in their future. Over the past several years, we have seen the SPAC sponsor group evolve to include new players (e.g., private equity, CEOs, COOs) and when COVID hit, the sponsor group expanded even further driving issuance.

Our outlook for 2021: This January was the most active month for SPACs on record.[3] We're seeing this trend continue. Why? SPAC sponsors can be handsomely rewarded if they are able to consummate a merger with an operating company, and this is providing an incentive for sponsors to risk their capital by launching a SPAC. And, because they get two embedded options when they buy a SPAC IPO, investors have been willing to provide capital to this new crop of SPAC sponsors. By buying a SPAC at its IPO you get one share of common stock and one warrant (or fraction of a warrant) which is only valuable if the SPAC sponsor consummates a deal. With respect to the common stock, as an investor, you always have the option to turn down a proposed deal and then get the treasury bill back. Therefore, the arbitrageur who invests in the IPO gets the potential upside with the common stock, provided the sponsor finds a great deal, and he also has the warrant as a second option and the downside protection provided by the trust account.

What risks should I be aware of in arbitrage strategies?

Two things can happen to realize risk in these strategies. First, a global meltdown in the markets, like the Global Financial or COVID crises, can cause most securities to trade down. In these extreme instances, even if you have hedged your investments on the short side, they may not be able to compensate for the loss you may see on the long side. Secondly, if you have a shorter time horizon, you may miss the subsequent recovery.

Different arbitrage strategies are subject to varying types of risk:

SPACs: These vehicles invest in treasury bills, which we believe to be some of the safest assets. One of the risks of investing in a SPAC is the loss or forfeiture of any potential appreciation it might make since its IPO.

Convertible Arbitrage: The risk here is a jump to default. We try to mitigate this through diversification, so we are more likely to hold instruments that can be hedged well – like equity-sensitive securities, where we can apply a direct hedge by shorting underlying stock vs. credit sensitive securities where we may be subject to more downside potential.

Merger Arbitrage: The risk is that the deal does not go through. We try to manage this risk through position sizing. When a merger is announced, the market typically reacts positively. The first question we ask is where will stock prices trade if the deal falls apart? That will limit how much we are willing to invest.

In the case of both convertible and merger arbitrage, there are two underlying contracts – the indenture agreement and merger agreement – that keep the metaphorical rubber band from breaking.

I missed the opportunity in Q1 2020; can't I just time my investment before the next big dislocation?

A sharp rebound happens quickly, and it's hard to time that exactly. We are largely through the dislocation of COVID but not through the opportunity.

We think the merger opportunity will be much better this year than it was last year. Given the post-COVID and post-election restructuring, we think we will see more opportunities in this space. We believe the SPAC market will continue to issue at a record pace, which will end up supporting not only these deals but the other arbitrage markets as well. For example, when a SPAC becomes a public company and they want to raise capital, they may issue convertible bonds. These companies, which are somewhat volatile with low cashflow and higher growth opportunities, are typical convertible issuers and will feed the convertible new-issue market. Similarly, if you have a store of new companies, they can replenish the pipeline of merger opportunities. We think this could indicate/move us toward a return to a really nice normal. And, by investing in a multi-arbitrage strategy, where the correlations between underlying strategies are far less than one, you can pull more levers to help capitalize on opportunities and mitigate downside.

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[2] Source: AQR, SPACAnalytics. Data as of January 31, 2021.

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