Water Island Capital

The ArbCast – Episode #20: Catalyst-Driven Credit – Mid-Year Strategy Update and Outlook

Jordan Hoerl: Hello and welcome to ArbCast, Water Island Capital's podcast series where we strive to provide investors with concise and timely insights into the world of event driven investing. I'm your host, Jordan Hoerl, and joining us today is Gregg Loprete, Portfolio Manager of the Water Island Credit Opportunities Fund, ticker ACFIX.

Today, we'll touch on the rocky start of the year for fixed income markets, where markets could go from here, and how Gregg intends to navigate choppy waters moving forward. Gregg, thank you for joining us.

Gregg Loprete: Good morning, Jordan. Nice to be here. Thanks for having me.

Jordan Hoerl: So Gregg, it goes without saying the first half of 2022 was difficult for most investors. There were few places to hide with risk assets down pretty much across the board. Do you mind sharing some of your observations today, what you're seeing, and perhaps juxtapose that with what you were thinking just six months ago?

Gregg Loprete: Yes, absolutely. It's been a difficult first six months of the year. If you recall, at the end of 2021, everybody was already talking about higher rates and inflation, a lot of that due to the pandemic. But when we got into the first part of the year, we started to get some inflation prints that appeared to show that inflation was, in fact, sticky rather than just a transient. And so the market really felt that the Fed was behind the curve and the Fed had to act a little more aggressively, certainly more than people had initially expected or wanted them to. And then really exacerbating everything further was the Russian and Ukraine situation which led to markets selling off, led to higher fuel energy prices around the globe, and that really impacted things a lot.

So, essentially what had happened there was that equities continued their sell off, which really began in the fourth quarter, particularly in technology. But then as rates were going higher, a lot of the longer duration products - investment grade credit, mortgage-backed (securities), even high yield which is more of a risk-on and a spread product - those markets sold off aggressively, particularly in the second quarter. So, with spreads wider, it also seemed like everybody was running for the exits.

I don't know if this is a situation that has been more extreme in the past few years because of social media or maybe because of the number of electronic trading platforms, whether it's ETFs or other risk parity types of funds where they just get aggressive and then they tend to be more momentum driven. But as soon as something starts trading down and picking up speed, on the way down or on the way up, it seems like everyone tries to follow. So we had a classic situation here, particularly in the second quarter, where everybody was trying to get off the ship at once, and we had some pretty dramatic drawdowns during that quarter.

So that really shaped, I think, everybody's thinking, particularly with risk. People were definitely getting nervous. They started to think about and talk about this leading to a recession, that the Fed would perhaps have to tighten even more in order to induce some type of recession just to slow down inflation.

So we left the second quarter and the first half of the year with pretty negative sentiment in the market, and that's really where we are today.

Jordan Hoerl: Thanks Gregg. So with that in mind, and also considering we've had somewhat of a relief rally here in July so far, what are some of the possible outcomes you see playing out through the end of the year and how do you envision them impacting the fixed income markets?

Gregg Loprete: Great question. Everybody's asking that question. I think the first thing that we're talking about is with respect to inflation and that's dominating everyone's conversations. That's going to drive rates; it's going to drive Fed policy; it's going to drive our investment decisions.

So, I think that the first thing to think about is where are rates going? Where is inflation going? So, the first outcome is that inflation continues. It does not abate. And in that case, the Fed is going to have to continue to get more aggressive. And if we follow that scenario through, depending on how aggressive the Fed is and how much rates go up, it's more than likely to lead to some type of recession in the future.

And so you really have a situation where not only are you getting impacted on your higher quality rate-sensitive types of names, but in a recession scenario, certainly your risk products - whether it be equities or high yield - are going to get hit hard. So that's a pretty bearish scenario.

The next thing I think we're facing is, is the Fed doing enough? Is inflation going to be tamed? And right here, we're at the beginning of the second half of the year and it feels like we have a little bit of a risk rally here. I think that partially is because we've had some rate stabilization. The market, I think, in general thinks the Fed is at least telegraphing that they want to and have definitely stamped their authority on inflation in the sense that they want to keep it under control, they realize how big of a problem it is, and they've had buy-in from the Biden administration. So, I think those are good things out there. And it feels like the market has picked up on this. We have rate stabilization currently. The 10-year is hovering somewhere around 3%. The 5-year is a little bit below that. Inflation expectations, by some of our measurements, seems to be coming down which is a positive. So, we've seen a little bit of a relief rally. That right now is what we'll call the base case. You know, the bear case is the one I talked about previously.

The last case being a more bull case. I think it's more of a continuation where inflation miraculously comes in, the Russia-Ukraine crisis is resolved and everybody is happy, and maybe markets rally from here.

So, I don't know that we're factoring that one in, but I think the prior two certainly. Right now with rates stabilizing, that's good for our markets, particularly for corporations. You know, we do look at corporate credit, so it is a window that's opening up where we could see a lot of companies coming to refinance. It does make corporate planning a lot easier in that sense, and also for homeowners. For people looking at mortgages and the like, I think it's a positive for them because they can see some stability. They don't feel so rushed to get their mortgage locked in like maybe they did over the prior couple of months.

So those are really the things that I'm looking at. I'd say myself and probably the firm tend to be much more conservative. So, I think we really have to prepare for both scenarios. In particular, the recession scenario because I think that's the more adverse of the two. So, I think all of our thinking is going to be looking at those two scenarios and making sure that we're protected on the downside there. It’s a tricky thing to do, but it's something that we're keeping very close to us in our thoughts and how we plan the remainder of this year for all of our funds.

Jordan Hoerl: Walking through those scenarios is helpful, Gregg. Now in previous ArbCast episodes, you've detailed your catalyst-driven credit approach and highlighted how primarily investing in near-term idiosyncratic events has helped mitigate credit and interest rate risk. And as we look at year-to-date performance as of July 15th, the fund is only down 4.71% while the Bloomberg Agg and ICE BofA High Yield indices are down 9.80% and 12.43%, respectively. So, on a relative basis the fund has held up rather well. But for our listeners' sake, can you share what hasn't worked as well as expected this year and what have been some of the biggest challenges for you?

Gregg Loprete: Yes, good question. Really the most difficult situations that we've faced this year were in the softer catalyst events where the underlying companies were really being questioned about their ability to grow, or they were faced with revenue challenges that were brought about by supply chain issues.

So the market was really intolerant of any shortfall, and if there was a lack of dedicated buyers for this type of name, then bonds would gap from call it par levels to distressed levels in a matter of days. So it was to me a scenario that we really have not seen in a number of years, and I think the last time that we saw this was during COVID when things gapped down so dramatically. But here it was an idiosyncratic event. So what we had to do in these situations - and we did not have many of them at all - but of the ones that we did have, we had to assess and say are these fears real? If we go into a recession, is this company going to be able to get the financing it needs to push out its maturity wall? So, we took action on a lot of these names, whether it be hedging or exiting the positions.

So those are really the most challenging types of names, and that's to some degree shaping our thinking going forward. So that's really what hasn't worked this year.

Jordan Hoerl: Thanks Gregg. Given some of the scenarios you mentioned earlier and the potential volatility we could experience during the second half of the year, how do you plan on managing the portfolio moving forward? Do you plan on adjusting the playbook?

Gregg Loprete: So the playbook for the second half of the year is not going to materially change, but I think the way that we approach every position will be with a much more conservative bent. What I mean by that is looking at hedges around that position. Thinking about downsides in particular, what if we have that recession scenario, is our downside going to be 20% lower than what we think it is?

So, that's going to really impact our position sizing, it's going to impact the way that we're hedging each individual position, perhaps our overlays on the portfolio with hedges, but most importantly is that we are going to continue to focus on our catalyst-driven approach. And the one thing I will say, and we've done it over the course of the first and second quarters, is we've been building the number of hard catalysts in the portfolio. On the soft catalyst side, we're now putting against those much heavier hedges, and these hedges are designed so that if the markets go in the opposite direction, we can still be okay by using the options market and so forth. We're looking at the downside scenario also with respect to recessions in those soft catalysts.

With the hard catalyst names - these are things like mergers, acquisitions, spinoffs, things that have a definitive timeline, are governed by a merger agreement or some other type of agreement - those are the names that we've built up from about a quarter of the portfolio in early Q1 to half of the portfolio at the end of the first half. And so, by building those hard catalysts in the portfolio, that should be really good going forward. One is that these have a high probability of being completed, particularly if the market is trading down or if it's trading up. And the second part is because of the volatility that we've had, the merger names in the portfolio are trading at much, much wider spreads, and so we're able to capture those types of things in the portfolio.

And the last part that we've been looking at pretty closely is we've been moving up the capital structure in the portfolio. And what I mean by that is typically a high yield bond that we may buy that's the target company that's subject to a merger, we may buy their high yield bonds because we think that they're going to be redeemed. Often when you have a recessionary market or a rough market, the downside in that increases during your holding period. So, they will undergo some type of downside revision during your holding period. The deal may in fact close, and it should go back up to par or whatever your redemption price is. But you do have some more downside with those names. So, with the higher spreads in the market, we've been able to move into the bank loan market where a company - call it the target company - will have their debt refinanced if the merger's completed, but now we own something that's really top of the capital structure. It's a floating rate security with a higher credit rating, and those things really help to mitigate downside on the position. So that's a place that we've been increasing our allocation to based on the specific deal.

So those are things you can call a playbook, but it's really a combination of things that give us downside protection and allow us to capture the wider spreads that are in the market. So, in the second half of the year, hopefully we can expect less downside in the portfolio, but we can also capture a fair amount of that upside that's been given to us and other investors due to the volatility in the market.

Jordan Hoerl: Thanks, Gregg. I'm sure Investors appreciate hearing you're focusing on mitigating the downside as you find attractive opportunities and wider spreads. You know, that also highlights a benefit of your catalyst-driven strategy. That being, you have a number of different tools at your disposal. You just mentioned merger arbitrage and looking at adding more of those names to your book. Can you share with listeners what other tools, if any, do you anticipate using more in this market and which will be kept in the toolbox, so to speak?

Gregg Loprete: Yeah, that's a good question. So in the fund we do have the ability to implement long-short strategies. As you mentioned, merger arbitrage is definitely one of them. That really points to the harder catalyst events that we're putting into the portfolio. So, we will be using what we would call a merger arbitrage strategy, where we buy the target company's debt and in some cases we may short equity against that to hedge the position. Or we might buy put options, whatever that might be.

But depending on the situation, we can also employ a convertible arbitrage opportunity where we're effectively long the convertible (bond) and we're short the underlying common (equity) to hedge out the equity risk. Then for some of what we call our yield-to-call positions, where we expect a company to be redeeming debt before the maturity date, there we're going to use something that we would call capital structure arbitrage. In this case, you could think of it as a long position in credit with some type of equity hedge, whether that be a put option or short stock versus a call option, that sort of thing. We're really using all these currently, and I think they allow us to take advantage of any types of gaps in the market. The hedges not only help us on the downside when the markets are soft, but they do give us a trading opportunity. If things rally, then we can reset those shorts in the portfolio.

So, all these tools really help us and I think I'd be a lot more nervous if we were just a long-only fund and I had to just buy a bond and hope that it was going to have a straight line to maturity or the call date, but those may not have that luxury during the second half. So, we're using the merger arbitrage strategy. We're using the convertible arbitrage strategy - really in busted names, names that are trading close to their bond floor or in what we call high convexity names (that means they're trading close to their bond floor and they have kind of an out-of-the-money call option in them). Those are names that we would also look at, again, using a convertible arbitrage strategy. And again, with the yield-to-call names, we're really using that capital structure type of strategy.

Jordan Hoerl: That's interesting. So briefly moving on to rates, it seems the latest expectations are for continued Fed hikes through 2023. Considering you have a shorter duration portfolio and the return potential for spread based strategies like merger arbitrage is typically inclusive of short-term rates, is it fair to anticipate the return potential, at least for those names, would be better with each additional hike?

Gregg Loprete: Definitely. We saw that in the first half. If you go back a year ago and look at a typical merger arbitrage name, we might be looking to make an annualized return of 5% on that name. So we buy the bond of a target company, we clip coupon, we get redeemed say six months after, and in a good name we might get 5%. In the last month, we've been putting on names that are now low double digits.

So, what's nice about this strategy is that it's a very short duration portfolio, particularly the merger arbitrage types of names. As those roll off, we're able to put that cash into these new deals that are not at 5% spreads, but are now at low double digit spreads. So, I think that's what's nice about this type of portfolio. There's a natural roll that goes on. We don't have to go into the market and sell positions. It's more like the deal closes, the bonds are redeemed, we walk in on a Monday morning and basically we have cash in our account because the company has redeemed the bonds, and then we can go put that to work. So that's been a luxury and something that I really like about merger arbitrage as a strategy, and we're going to continue to use that going forward.

With the other types of names, those could be a little bit longer dated, but as I said before, we're using those hedges to try to insulate the principal risk there. That should allow us to clip coupon and to generate income in the fund for investors without the negative downside there that I think a long-only fund would experience.

Jordan Hoerl: Thank you. So Gregg, there's one more thing I'd like to ask you. Everyone's been hearing a lot about the saga between Twitter and Elon Musk. It seems like there's a new headline just about every day now. Is this a situation you've been following, and if so, are there ideas that you've been able to consider for your portfolio?

Gregg Loprete: Yes, it is a deal we are following very closely. I guess we could call it the world's largest soap opera right now, at least the largest corporate soap opera. Forgetting about what we do for a living here, it's entertaining to just watch this and to watch the big personalities and so forth. And the stakes are growing.

But this is our business. It's a merger deal. There's been a lot of color around the situation - a lot of tweets and a lot of volatility. But our basic thoughts are that the merger contract between Twitter and Elon Musk is very tight. Musk really has to prove that the bots issue is a material adverse effect. We think that the financing for the transaction is already locked in by Morgan Stanley. And as you may know, Twitter has recently filed suit in Delaware with the Delaware Chancery court, and the judge that's been assigned in this case had made a landmark decision a few days ago of forcing a buyer to complete a deal. So, we think we have some precedent here with that judge.

So overall, yes, it’s very entertaining. Those are our general thoughts about the situation and it's certainly going to continue in the second half of the year. But the volatility from either Musk's tweets or lawsuits, whatever it might be, has moved the company's bond and stock prices really dramatically during the second quarter, and it's probably going to do the same going forward.

What's nice about this situation from my perspective as a credit investor or a capital structure investor is that these moves have led to a mix of trades in the credit portfolio which revolve around the completion of the deal. Twitter obviously has equity, but they also have high yield bonds and they also have converts. So, we've been able to invest across the capital structure where we can invest in a significant way, and where we can reduce a lot of the downside risk with respect to a deal break but also capitalize if this deal goes through.

So it’s a pretty exciting deal to look at and to follow, and I'm happy that we can invest across the capital structure because I wouldn't want to just make a binary bet on if the deal goes through or it doesn't go through. Here we at least have some tools at our disposal to invest in this way with respect to the Twitter deal.

Jordan Hoerl: Thank you. I'm sure we'll be getting plenty of updates on the situation, not just from yourself, but all of financial media, and it'll be interesting to see how it plays out. Gregg, thank you so much for your time today. I really appreciate the color and insight you gave us.

Gregg Loprete: Thanks Jordan. It was good to be here and good chatting with you.

Jordan Hoerl: Well, we've been speaking with Gregg Loprete, Portfolio Manager of the Water Island Credit Opportunities Fund, ticker ACFIX. For those listening who may not be familiar with Water Island Capital, we are an asset management firm with a proven 20-year track record in event driven strategies across public mutual funds, private investment vehicles, and ETFs, allowing clients to choose the best format for their exposure. For more information on our funds, please visit our website arbitragefunds.com or call our resource desk at (800) 560-8210. Thank you for joining us.

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As of July 16, 2022.

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Performance through 6/30/22: ACFIX (I class), -4.25% (one year), 2.45% (five year), 2.44% (since inception 10/1/12); Bloomberg U.S. Aggregate Bond Index, -10.29% (one year), 0.88% (five year), 1.54% (ten year); ICE BofA U.S. High Yield Index, -12.66% (one year), 1.95% (five year), 4.41% (ten year). Performance quoted represents past performance and does not guarantee future results. Investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than the original cost. Current performance may be lower or higher than the performance quoted. For performance data current to the most recent month end, visit http://arbitragefunds.com or call (800) 295-4485. Returns shown above include the reinvestment of all dividends and capital gains. Returns greater than one year are annualized. Total Annual Fund Operating Expense for ACFIX is 1.52%. The adviser has contractually agreed to waive fees in excess of 0.98% for ACFIX until September 30, 2022, excluding the effects of taxes, interest, dividends on short positions, brokerage commissions, acquired fund fees and expenses, and other costs incurred in connection with the purchase or sale of portfolio securities. Without such fee waivers, performance numbers would have been reduced.

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