Water Island Capital

The ArbCast – Episode #21: Catalyst-Driven Credit – 2023 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 briefly recap the strategy's performance in 2022 - a year in which it stood out positively amongst peers and major market indices – and we'll also touch on the current state of credit investing and his outlook for 2023. Lastly, we'll discuss how he's positioning his portfolio in response to those items.

Gregg, thank you for joining us.

Gregg Loprete: Hey, Jordan. Thanks for having me.

Jordan Hoerl: It's always a pleasure. So, last year was the worst performing year for credit on record. Specifically, the Bloomberg U.S. Aggregate ("Agg") had its worst year since its inception, down about 13%. We know this came about for two primary reasons; yields were near historic lows at the same time that rate sensitivity had been at its highest level in decades.

As we've discussed in the past, your catalyst-driven credit approach seeks to isolate the portfolio from credit and interest rate risk. So, it's no surprise you outperformed the Agg by over 10%, but the fund was down slightly. So, I guess the question would be how would you assess the fund's performance last year, and perhaps you could talk about what worked and what didn't work?

Gregg Loprete: Sure, happy to talk about it. Last year, as everybody knows, it was a very challenging year for both fixed income and equity markets. And on a relative basis, we can be happy about the fund's performance. I think we were well within the bands that investors would expect, certainly in a year like last year.

So, happy on that front. Of course, as a manager I'd love to be producing absolute returns, positive returns in every year, and I think the nice thing about having minimal drawdowns from last year is it shouldn't be too hard to bounce back this year. Getting into the year already, we've done a pretty good job of bouncing back and returning some of that capital, some of those small losses to investors.

I think the way that we got through it is really because of our differentiation, and I think a lot of people who know our fund know that we do run a catalyst-driven fund. It's a fund where we have a combination of hard catalysts like mergers, acquisitions, and spinoffs, and then we have softer catalysts which could be things that are a little less definitive. Things like refinancings, de-leveragings, that sort of thing.

So, when you enter a market like last year, the hard catalysts - meaning the mergers and so forth - tend to stay pretty well supported during poor markets. And that's really the whole intent and goal of this strategy. But when you entered a year like last year where interest rates were rising so rapidly and you did have some panic in the market, there's a huge amount of de-risking out there. And with that de-risking comes investors questioning whether those mergers are going to get done or not. So our job is to figure out if those mergers are going to get done and close, and if we're going to end up having our bonds redeemed at the end of that transaction.

But despite those things we saw drawdowns even in some of our harder catalyst names. Soft catalysts do have a little more beta sensitivity. We reduced that by hedging those positions as well. But through the first half of the year, we had our largest drawdowns during the year at that point. So what we looked to do at that point was try to look through the noise, and there was a lot of noise last year. There were a lot of things to think about with rates going up, with inflation, and with recession talk. But what we really wanted to do was concentrate on the hard catalysts, those names that later in the year we thought were going to get done, where we'd have the bonds redeemed regardless of what happened in the overall markets.

And then the other part was playing defense a little bit. That is, let's assess some of the softer catalysts and think about if we went into a recession or a heavy recession, would those companies be able to refinance their debt? Would they be able to do the things that we thought they were going to be able to do when markets were a little more open and a bit more positive with their outlooks?

So, what we did is we planted those seeds as things were selling off in the first half of the year, and what we had in the latter half of the year where we made back a lot of our mark-to-market losses is that as those deals started to close, we essentially had a pull to par in a very large portion of the portfolio. So beginning of the year, I think we had somewhere around 20% in hard catalyst, and by the end of the year we had something north of 50%, which is a pretty high amount of capital that's invested in hard catalysts. So that part of the strategy really did help pan out and brought us into a situation now, here at the beginning of the year, where those deals have closed and now it's really just a matter of finding some of those new catalysts, those new mergers, and also paying close attention to some of the softer catalysts.

So that's kind of a long-winded way of talking about the year. A first half that was difficult for everybody, but also how we really tried to look through that and succeed or have more success in the latter half of the year.

Jordan Hoerl: Thanks, Gregg. That color is really helpful.

One of the things you mentioned is that things have bounced back a little as we've started the year. We're now a month in and fixed income as a whole has rebounded to the tune of almost 4%, for both the Agg and High Yield. Q4 was, as you know, a positive quarter for the asset class as well, and there seems to be some optimism and opportunity depending on what part of the market you're looking at. But there's also a lot of uncertainty still - things like the looming debt ceiling, Fed rate policy versus market expectations, are we going to experience a soft landing or a hard landing, recession risk, et cetera. These are a handful of some of the hot topics. With all that in mind, what would you consider the bear, base, and bull cases are for 2023 given some of these variables, and what do you believe is most likely to unfold?

Gregg Loprete: Yes, great question. I think at the end of the year we were really faced with the same set of risks and opportunities as the rest of the market. And that was really about what is the data going to look like? What is the Fed going to do? Are we going to see inflation come down? Are we going to be in a recession?

And I think the most important thing that we've seen over the last month or so with the data is the Fed appears to have - I don't want to call it defeated inflation - but they've certainly reigned things in. At least it appears that inflation is not the problem that we saw it as a year ago and we're seeing it in the data. But more importantly, we're seeing it in the rates market. And one of the prerequisites, I think, for a successful early part of this year was that we saw rates stabilize. And the way that we know that rates are stabilizing is because we see fixed income and rates volatility declining. When that happens, companies, investors, even consumers, they can make better decisions about what to do with their businesses, what to do for home purchases, and what to do for just buying in general. What is their expense account going to look like?

So, we saw things like commodities drop. We had fuel dropping. And so all these things combined - lower inflation, better data from the Fed. Certainly, the Fed most recently didn't pause, but they backed up in their last statement on February 1st from 50 basis points down to a 25 basis point raise in the Federal Funds rate.

So all those things were contributing to more of a positive outlook for investors. We saw that through January. I think the other thing that attracted people to the market was just that rates were so much higher. Yields that you could get on a corporate bond, on a high yield bond, on an investment grade bond – these are levels that were so much higher than what they had been just a year ago.

And so even though my own opinion is that high yield spreads at this point are probably tight relative to thinking about the future and if we go into a recession, I think the absolute yield that was out there, and we started somewhere close to 10% at the beginning of the year or let's call it the end of the fourth quarter, that yield was really attractive for investors. So I think that drew a lot of people in and we're seeing that not just in high yield and investment grade, but we're seeing that because rates are steady. We're also seeing the equity markets take off.

So your question was really about bull, case, base case, and bear case. Right now it does seem that the base case is probably a 75% chance that we have some type of soft landing, that inflation is subdued or brought under control, and that rates continue to stabilize. Now that's not to say that we aren't going to have days or weeks where we have data that refutes that and it pushes the markets in the opposite direction, but I think the consensus right now seems to be that we will have that soft landing. Fingers crossed, hopefully we do. Hopefully the consumer doesn't have to go through the real strain of a hard recession. That would definitely be a positive on a personal level and an emotional level for people and obviously for investors.

The bear case could be if we see inflation spiking. That's always going to be based on some event that we haven't foreseen. It may be that oil prices go up and that contributes to inflation. It could be something related to like what we had last year with the Ukraine. But we just don't know what that could be. But I think given the risk that we've seen in the markets over the last 10 to 15 years, the best thing to do is to expect that something happens that we didn't expect to happen.

And then the bull case would probably be that we continue to have a short-term rally. We continue to see spreads contracting. And that's probably going to be more like a 10% to 15% probability that it happens. So that's really how we see the markets right now and what we foresee going out for this year.

Obviously, it's going to change every time there's a data point coming out, whether it's Federal Reserve, from a conference, from their post-meeting conference calls, or if it's just every day that we get data out there on employment and wages and that sort of thing.

So, I would expect some volatility but I would also look to see what rates are doing and see if that rate volatility stays subdued. And if that's the case, then that probably sets a firmer stage for markets to rally a little bit more. And then we'll have to go look at earnings, and that's all going to be based on whether we are in some type of recession and based on expectations in the markets, whether we see better earnings, or we start to see some drawdowns because earnings are weaker than we thought.

So those are really the scenarios that we see big picture. Hopefully that helps people think about maybe where to put money this year and where not to put money this year.

Jordan Hoerl: Thanks, Gregg. Speaking of where to put money, given the expectations you just discussed, where are you finding opportunities today and how are you positioning the portfolio or putting money to work based on those expectations?

Gregg Loprete: Well, really a couple things. As I mentioned before, we've had a lot of our hard catalyst names roll off at the end of the year and into the beginning of this year, and that's been really good for the portfolio. So, the number of hard catalysts has come down which is okay given the current environment.

But what's happening is that as the credit markets open up, we're seeing a lot more opportunities with the refinancings in the market. We've had a number of positions just in this last month that are now coming to market. We thought that these companies were going to come to market last year, but because rates were so high and there was so much volatility, they chose to put it off. Now that we've seen some stability these companies are looking to refinance their debt. So these soft catalyst events are working out for us, and I think what's going to happen is we'll now see those softer catalyst events work out and come to completion over the next quarter or so.

The other part of our book are the hard catalysts. And even though in the first month or so of the year we haven't seen a great number of mergers announced, they take time to develop. What we have seen is we've seen a lot of headlines about companies hiring bankers. We've seen approaches made for another company by either strategic or private equity, and those are going to take another few months to a quarter to pan out. But I think those are going to happen, those hard catalysts. So the reason I think that they're going to happen is because you're coming off a year like last year where equity prices declined so dramatically. You start to get some buyers out there that are looking at the market and these assets are very cheap now. You also have the sellers or the target companies that are saying our stock has declined so much and I don't want to sell down here. So what you have is effectively a really wide bid-ask, but as time goes on the equity prices go higher.

And as the credit markets firm up, then you're going to have a lot more transparency or a lot more clarity on these transactions. In other words, the bid and ask will get a lot closer or close, and I think in the next quarter or so you will see these deals become definitive.

So, the whole reason I talk about this is because as our softer catalyst events play out with the open credit markets, with companies refinancing their debt and the like, we're going to start to see a lot more of the hard catalysts.

The game plan at this point is to make sure that our soft catalysts are working out the way that we had planned. And then the other part too is to be very vigilant of the hard catalysts when they come up because that's really how we'll transition the book over time. I can't be a hundred percent certain that this is going to happen, but when I look at it over the next quarter or two it seems to me that we're heading in that direction.

Certainly, my view is bolstered by the fact that you do have lower volatility in the markets, you do have stability on rates, and I think that's going to drive a lot of the buying activity. So I could feel relatively confident that we'll see that over the next quarter or so.

Jordan Hoerl: That's very interesting. There were a number of headlines that had discussed how mergers and acquisitions cooled off in 2022 with all the uncertainty, but it sounds like there's a decent pipeline building up and we could potentially anticipate some more activity moving forward into this year.

Switching subjects, one thing that we hear a decent amount from our clients is - given the uncertainties in fixed income - there are differing levels of thought. We hear on one side that folks are positioning their clients in things like short-term money markets and treasuries. On the other side we hear a number of folks who think that perhaps the Fed has gone too far and they'll have to start cutting rates, and they are instead going long duration.

With those two narratives out there, how do you feel that your strategy fits in?

Gregg Loprete: Good question. I think there's no one place to invest, in my opinion. A lot of people say why aren't you doing this and why aren't you doing that. A lot of that comes down to what you're trying to deliver for your clients.

Clearly there are funds out there that specialize in providing income to their investors. A lot of those funds are longer in duration. Generally, the longer duration is the higher the yield you'll get, or at least the income generated from that fund will be higher. But of course we saw the pitfalls of that strategy last year when those markets were down so dramatically. So if you had all your eggs in that basket, you were probably not so happy.

But looking into this year now that you have rates that are higher, that you've had the principal amounts decline over the last year, a lot of people are saying now it's probably not a bad time to get back into those markets. And I wouldn't disagree with that. I think that it's prudent to be diversified, and I'm just talking about the fixed income landscape now, not equities. But with fixed income, I think it's smart to be diversified. I think you probably want some stuff that's longer duration. I think you probably want some things that are shorter in duration. And a lot of people on that short duration are simply saying I can go to my bank and get a CD, or I can buy a three-month or a six-month treasury and get 4% or 5% or something, and that's fine. I think some of that has to do with your view of what's going to transpire. If you think over the next year you'll get that 5% and you're going to be happy with that, then that's a fine investment.

But that's all about the opportunity cost. So, if you take that same investment that may have delivered 30 basis points over the last month, but you could have put it in investment grade or high yield or someplace else, you're talking about a 30 basis point return versus some of those funds and those indices that are up three to five percent. So that's the opportunity cost. It doesn't mean you were wrong. It just means that there are other types of assets that outperformed.

For us, I tend to look at us as being part of that solution, and I look at us as being on the shorter duration end of the curve because we do focus on catalysts that will transpire in six to 12 months. So, we're a short duration portfolio in general. But I also look at our short duration as different than say another short duration fund. That could be a short duration high yield; it could be a mix of different short duration asset classes; it could be asset backed securities; it could be mortgages; it could be corporate income and the like; it could be municipals. They may be focused on short duration, but they are – in a lot of cases - going to be very tied to the macro. Again, that's fine and good.

What we have is a short duration strategy that we're really making some type of spread over the risk-free rate. On top of that, we try to deliver - and I think we've been successful in delivering - returns that are really correlated more to idiosyncratic events. Meaning, we are invested in a merger or in a company that's delevering or refinancing debt, and as long as those events transpire, as long as they occur in the next six months to a year, we'll get paid on our bonds, we'll redeem those bonds, we'll get cash, and then we redeploy it into a new situation.

So that means that we, unlike a lot of those other short duration funds, have a strategy that is less correlated to the macro. So I still think, like I said before, there's a lot of different places to invest and I think diversifying is probably a smart place to be. And what we do is we provide diversification, short duration, but a short duration that is a lot less correlated to the overall markets.

So that's really how we fit into the overall scheme of things.

Jordan Hoerl: Well, Gregg, that color is very helpful. It's always a pleasure catching up with you. I appreciate the time you've given us and thank you for all your insight.

Gregg Loprete: Thanks, Jordan. It was a pleasure to talk with you today.

Jordan Hoerl: As a reminder, 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-plus 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 so much for joining us.

--

As of February 3, 2023.

An investor should consider the investment objectives, risks, charges, and expenses of the funds carefully before investing. The current prospectus contains this and other information about the funds. To obtain a prospectus, please visit https://arbitragefunds.com/ or call (800) 295-4485. Please read the prospectus carefully before investing. Investing involves risk, including potential loss of principal. Diversification does not guarantee against a loss.

The discussion of market trends and companies throughout this podcast are not intended as advice to any person regarding the advisability of investing in any particular security or strategy. Any securities mentioned are selected for discussion purposes only and may not represent current holdings of Water Island Capital, LLC ("Water Island") or The Arbitrage Funds. Our views, opinions, and estimates – including any forward-looking statements – are a reflection of our best judgment at the time of recording and are subject to change based on market and other conditions. Water Island is under no obligation to update or revise any such views or statements, except as required by law. Past performance is no guarantee of future results. Additional information about Water Island can be obtained from our Form ADV, which is available at https://adviserinfo.sec.gov. Please visit https://arbitragefunds.com/glossary for definitions of terms.

ACFIX has limited availability and may not be accessible to all investors. The fund is also available in other share classes. Please see the fund's prospectus for more details.

The Bloomberg U.S. Aggregate Bond Index ("Agg") covers the U.S. investment grade fixed rate bond market. The ICE BofA U.S. High Yield Index ("High Yield") measures the broad domestic high yield corporate bond market. Index returns do not reflect any management fees, transaction costs, or expenses. Index returns are for illustrative purposes only and do not represent actual fund performance. Indexes are unmanaged and one cannot invest directly in an index. Index performance is not intended to, and does not, parallel the risk or investment style of the fund's investment strategy.

Credit quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest). Investment grade – typically rated BBB or better – is a rating that indicates that a bond has a relatively low risk of default. High yield – typically rated BB or worse – refers to bonds with a credit rating lower than investment grade and are perceived to have a relatively higher risk of default.

Performance through 12/31/22: ACFIX (I class), -2.72% (one year), 2.89% (five year), 2.64% (ten year); Bloomberg U.S. Aggregate Bond Index, -13.01% (one year), 0.02% (five year), 1.06% (ten year); ICE BofA U.S. High Yield Index, -11.22% (one year), 2.12% (five year), 3.94% (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. Performance varies by share class. Total Annual Fund Operating Expense for ACFIX is 1.37%. The fund has entered into an Expense Waiver and Reimbursement Agreement whereby the adviser has contractually agreed to limit the total annual operating expenses of the fund so that they do not exceed 0.98% for ACFIX, 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. The agreement remains in effect until September 30, 2023, unless terminated at an earlier time by the Board of Trustees. Without such fee waivers, performance numbers would have been reduced.

FUND RISKS: Investments are subject to risk, including possible loss of principal. There can be no assurance that the fund will achieve its investment objectives. The fund uses investment techniques and strategies with risks that are different from the risks ordinarily associated with credit investments. Such risks include event-driven risk; merger arbitrage risk (in that the proposed reorganizations in which the fund invests may be renegotiated or terminated, in which case the fund may realize losses); active management risk; credit risk; convertible security risk; liquidity risk; market risk; sector risk; interest rate risk; short sale risk; hedging transaction risk; large shareholder transaction risk; leverage risk; high portfolio turnover risk (which may increase the fund's brokerage costs, which would reduce performance); counterparty risk; temporary investment/cash management risk; swap risk; options risk; preferred security risk; investment company and ETF risk; derivatives risk; LIBOR rate risk; currency risk; and foreign securities risk. Risks may increase volatility, increase costs, and lower performance.