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Alternative investment strategies: part 3

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In Part two of this series on alternative investment strategies, we described the most important strategies “trend following”, “global macro”, and “long/short equity”. In this Part three, we will be looking at approaches that are less well-known but equally tried and tested.

Merger arbitrage

The first approach is merger arbitrage. This strategy hinges on companies that try to strengthen their earnings power by taking over competitors in an environment of low earnings growth. The takeover price tends to exceed the share price of the takeover target prior to the announcement. Globally, we have seen numerous such transactions. Among the well-known companies that have taken over competitors were for example Johnson & Johnson, AT&T, and Bayer.

For this strategy to work, one would buy the shares of the takeover target in order to make use of the proposed premium and possibly sell short the shares of the company that initiates the takeover, given that they tend to decline as a result of the anticipated costs of integration. An example: company A is interested in company B, whose products would be suitably complementary to its portfolio. A therefore offers more than the current share price of B, which is EUR 100, i.e. EUR 110. The goal is to acquire control over B at some specified point in time. We can call the price differential a “package premium”. As a result, the share price will quickly edge higher to, say, EUR 107, given that somebody is prepared to pay EUR 110. The reason the share price is not rising to EUR 100 is that the transaction can still fail.

Now the merger arbitrage strategy calls for investments in the shares of company B. Two outcomes are possible: the takeover succeeds, and the share price rises to EUR 110. Or the plan falls through, for example if an authority issues a veto; in this case, the share price falls to EUR 100. Since takeovers tend to come with comprehensive preparation, failures are an exception.

Possible challenges to this strategy are changing circumstances such as a sudden increase in financing costs or a changed regulatory framework, as a result of which several takeovers might fall through within a short period of time.

Special situations

This strategy is based on a portfolio of shares issued by companies that are subject to radical changes. Such radical changes can be a merger with a competitor, a strategic realignment, the spin-off of parts of the company, the recently overcome risk of insolvency, restructuring, or changes in top management.

The expertise of the strategy managers is to evaluate such changes with regard to their impact on the company result and the share price, and to do so precisely (and indeed more precisely than other market participants). In the best-case scenario, the effects of these changes are isolated from the overarching fluctuations of the equity markets.

The strategy is a bit more difficult to handle if the portfolio consists of a low number of shares and thus harbours a large degree of individual risk; if the neutralisation of the equity market is being disregarded; or if the different situations unexpectedly become synchronised, e.g. several mergers with competitors are falling through within a short period of time, because the tax framework of a country has suddenly changed.

Long/short credit

The default risk (insolvency risk) of a company depends on the financial situation of the company itself but also on the overall economic conditions. This default risk is reflected in the price of corporate bonds and of credit default swaps (CDSs). Corporate bonds and credit default swaps are the instruments used most frequently by this strategy. The expertise of the manager consists in determining the default risk, however low it may be, precisely, and again, more precisely than other market participants. Only this way can the strategy benefit from the future development of the default risk.

In addition to individual credit default swaps, bundled CDSs are also available for many participants of the various sectors or for a time window in the future, and investors can take long and short positions.

Among the risks of this strategy is a possible late phase in the credit cycle that comes with a sudden general and drastic deterioration of the solvency of many companies in which positions have been taken.

Commodities

Much like alternative strategies, commodities, too, assume an in-between position: in contrast to the aforementioned strategies, they exploit other income sources, and their performance can deviate from that of shares and bonds, given that their valuation is subject to a phase shift. That being said, during the financial crisis in 2008 commodities were totally lacking in said portfolio independence at some points, which means that shares and commodities were losing drastically at the same time.

The main sectors are energy (crude oil, natural gas), agricultural commodities, industrial metals, and precious metals (among them gold). Gold assumes a special role as it only allows for a limited degree of industrial use. Therefore, the independence of this sector is particularly profound. Generally speaking, economic evaluations, production costs, and supply and demand determine the price of commodities.

The way commodities are accessed on the market is a special feature: it is usually facilitated via forward transactions (in their standardised version referred to as futures), since the storage that would come with a physical purchase is not possible. Forward prices (future) may deviate significantly from spot prices (i.e. current, actual prices at a certain point in time).

Volatility

The goal in most cases is to capture the risk (“insurance”) premium associated with volatility, and it is the difference between the implied volatility (i.e. as priced by the options) and the actually prevalent volatility of shares. In the absence of market stress, this premium will be positive. In an expanded version, bonds, currencies, and commodities can also be taken into consideration.

This strategy will face challenges if the risk premium suddenly turns extremely negative due to a crisis scenario (e.g. a stock market crash).

Another version uses price distortions (inefficiencies between the insurance premium for equities on the one hand and equity indices on the other hand) between the volatility of individual shares with regard to each other and with regard to an equity index.

Risk premium strategies

Risk premium strategies include a multitude of systematic strategies in the asset classes of equities, bonds, currencies, and commodities. They can be put into four categories. “Value”: assets bought cheaply at some point will outperform expensive ones. “Momentum”: winners and losers now will remain winners and losers in the near future. “Carry”: assets paying higher yields will outperform assets that pay lower yields. “Liquidity”: assets that are traded rarely will outperform assets that are traded often. These models are based on the expertise of security traders or academic research. The strategies can be used to build a diversified, stable portfolio.

Conclusion

Each one of these strategies has its own profile; an investor can choose one or more in accordance with his/her risk appetite. A fund product that combines different strategies on the basis of a thorough analysis of the market environment will ensure optimal diversification.

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