# Merger Arb Boosts Diversification

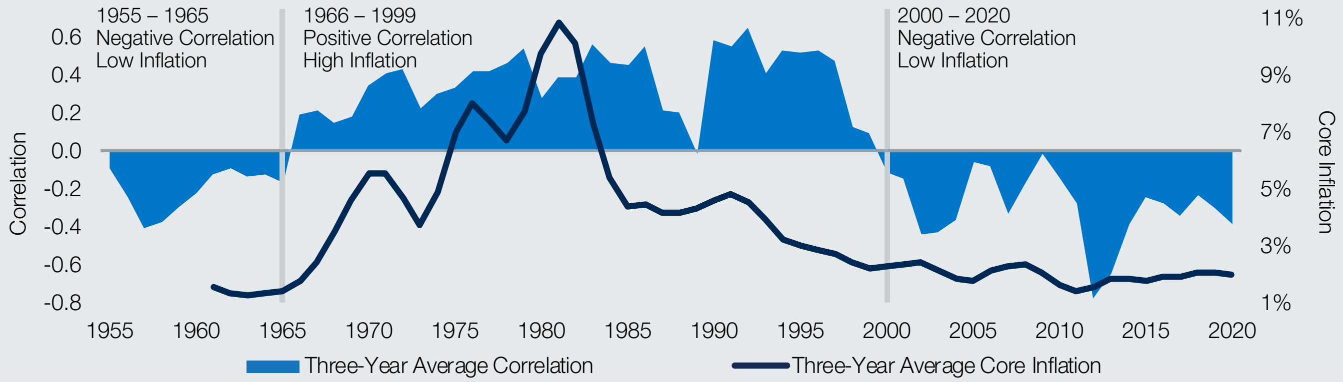
*An attractive asset class amid rising inflation and interest rates*

Traditional balanced portfolios of 60% stocks and 40% bonds have delivered attractive performance and diversification over the last two decades, driven by the negative correlation between stocks and bonds. However, the negative correlation of these two major asset classes hasn't persisted throughout history and it's possible that we could be entering a period of positive stock-bond correlation.

Historically, stock-bond correlations have differed based on the inflationary backdrop. During periods of relatively low inflation, reflected here as core CPI under 2.5%, the negative relationship between stocks and bonds has remained intact. But during periods of elevated inflation—such as 1966-1999—this trend reversed, resulting in a positive correlation between the asset classes.

## Inflation Impact

*During periods of low inflation, stocks and bonds have been negatively correlated. But when inflation rises and persists, there has been a positive correlation between those asset classes.*




Source: Bloomberg, Morningstar Direct.

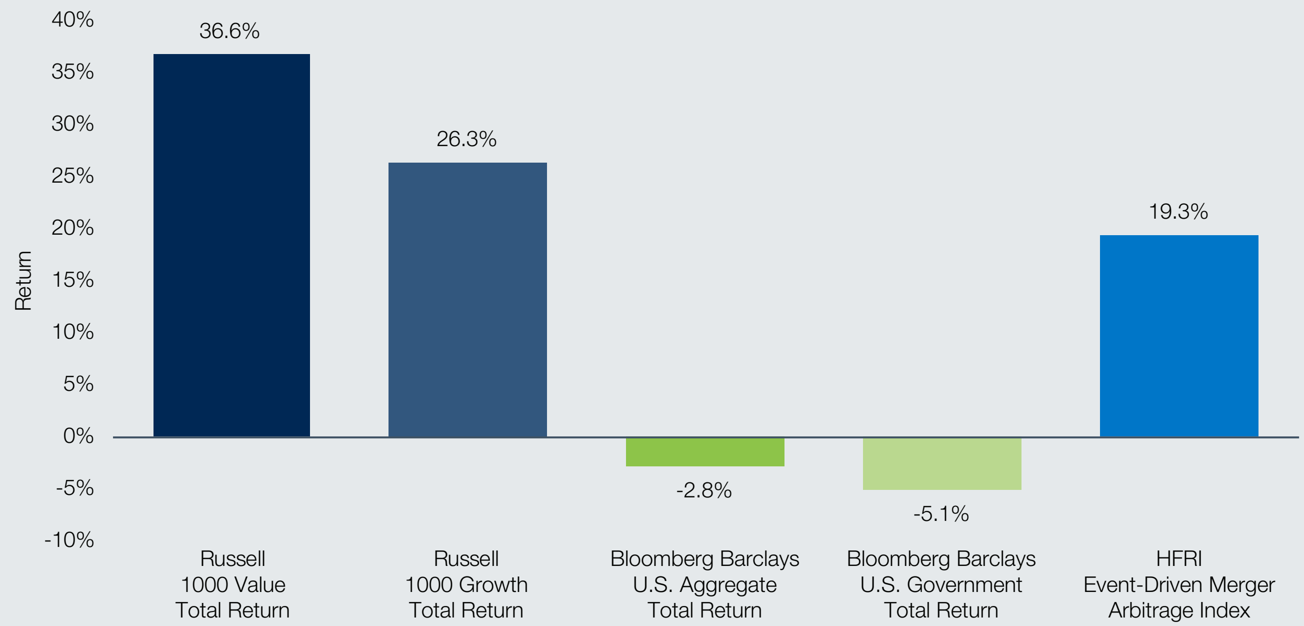
Recently, we have seen a notable pickup in inflation with the April core CPI rising 3% year over year. While this rise in inflation may prove to be transitory due to pandemic-related effects, it may be prudent for investors to consider protection for their portfolios in the event that inflation remains elevated.

Higher inflation often coincides with higher interest rates. Historically, conventional fixed-income strategies have confronted headwinds during periods of rising interest rates. During rising-rate environments, bond prices fall as interest rates rise, creating challenges for the traditional 60/40 portfolio. While equities, particularly value stocks, tend to exhibit more resilience in a rising-rate environment, an allocation to merger arbitrage strategies can offer upside potential as well as diversification benefits.

This relationship was on display between August 2020 and April 2021 when the 10-year U.S. Treasury yield increased by 1.09% to 1.65% from 0.56%. Over this period, the Bloomberg Barclays US Aggregate Index and the Bloomberg Barclays US Government Index generated negative returns while the HFRI Event-Driven Merger Arbitrage Index yielded positive returns.

## Protection Against Rising Rates?

*Merger arbitrage strategies have generated positive returns while bonds have faltered in the face of rising rates over the last eight months.*



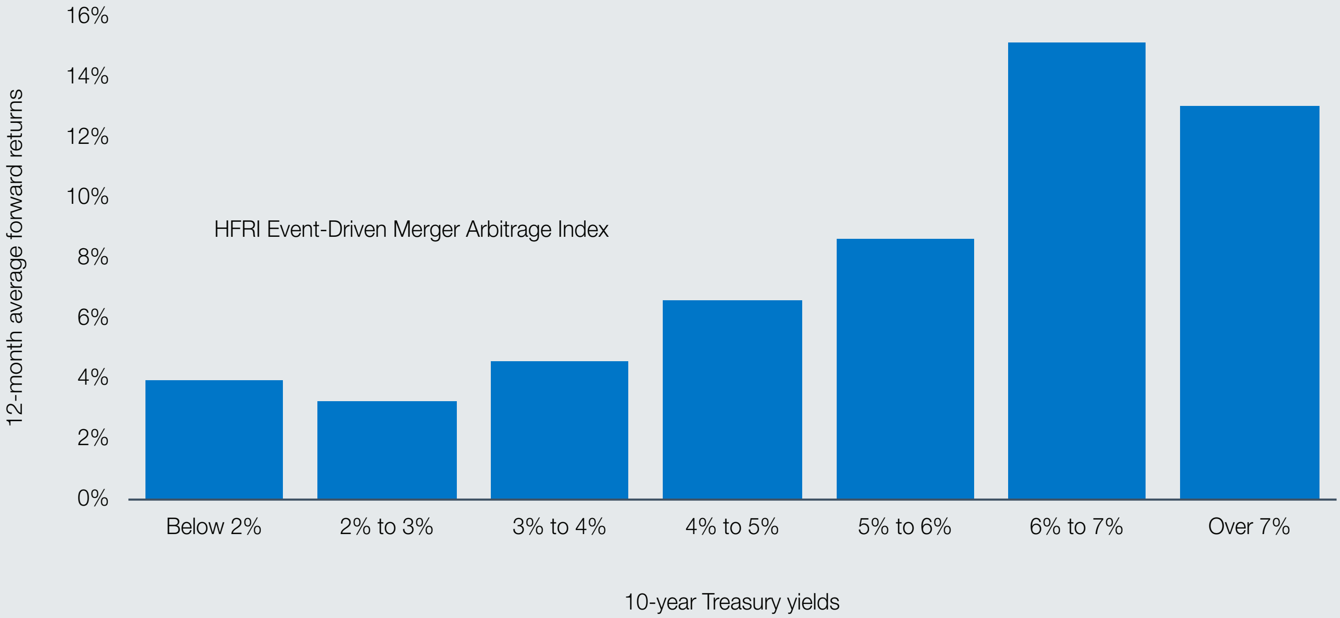

Equities-based strategies such as merger arbitrage and event-driven are traditionally riskier than investment-grade and U.S. government bond strategies. Please see the Appendix for more information.
Source: Morningstar Direct. 8/1/20 to 4/30/21.

**Past performance is no guarantee of future results.** Merger arbitrage and event-driven investing involve the risk that an evaluation of the outcome of a proposed merger, reorganization, regulatory issue or other event will prove incorrect and that a fund's return on its investment will be negative.

While fixed income faces a headwind from rising interest rates, various alternative strategies may actually benefit from higher rates. Higher interest rates have historically led to better returns for spread-related investments like merger arbitrage because as the risk-free rate increases, investors require a larger premium to assume the merger risk. Merger arbitrage funds depend on having an abundance of M&A events to invest in and the number of these events can vary significantly depending on the market environment. In addition, investors should be aware that the risk/return profile of a merger arbitrage strategy is relatively asymmetric, which means there is typically a larger downside in the case of a deal's failure than the upside offered when a deal succeeds.

## Capturing the Spread

*Higher interest rates and the resulting increase in borrowing costs have fueled returns in spread-related investments such as merger arb.*




Source: Morningstar Direct, Bloomberg. HFRI. 12/31/89 to 4/30/21.

Historically, performance for the HFRI Event-Driven Merger Arbitrage Index grew stronger as yields increased. As a result, allocating capital to a merger arbitrage manager may provide a portfolio with attractive risk-adjusted returns and diversification benefits from traditional equities and fixed income, especially if interest rates continue to climb (the opposite is true in a declining interest rate environment.) Recognizing these benefits and associated risks, OAM Research has recently increased exposure to merger arbitrage strategies across most of the firm's discretionary portfolios.

*To learn more about diversification and merger arbitrage strategies, please contact an Oppenheimer financial advisor.*

## Appendix

| As of 5/31/21 | YTD | 1 Year | 3 Years | 5 Years |
|---|---|---|---|---|
| Russell 1000 Growth Total Return | 6.3% | 39.9% | 23% | 22.1% |
| Bloomberg Barclays U.S. Aggregate Total Return | -2.3 | -0.4 | 5.1 | 3.2 |
| Bloomberg Barclays U.S. Government Total Return | -3.1 | -3.6 | 4.4 | 2.5 |
| HFRI Event-Driven Merger Arbitrage Index | 8.4 | 23 | 7.4 | 6.3 |
| Russell 1000 Value Total Return | 18.4 | 44.4 | 12.9 | 12.3 |

**Russell 1000 Value Index** measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000® companies with lower price-to-book ratios and lower expected growth values. The Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

**Russell 1000 Growth Index** measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000® companies with higher price-to-book ratios and higher forecasted growth values. The Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

**Bloomberg Barclays Capital U.S. Aggregate Bond Index** covers the U.S. dollar-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities. All issues in the Aggregate Index are rated Baaa3/BBB-/BBB- or higher (using the middle rating of Moody's, S&P, and Fitch, respectively) and have at least one year to maturity and have an outstanding par value of at least $250 million.

**Bloomberg Barclays Capital U.S. Government Index:** The index measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

**HFRI Event-Driven Merger Arbitrage Index** measures strategies that employ an investment process primarily focused on opportunities in equity and equity related instruments of companies that are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations which pre-, post-date or situations in which no formal announcement is expected to occur. Merger arbitrage strategies typically have over 75% of positions in announced transactions over a market cycle.

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In general, the bond market is volatile, and fixed income securities carry interest rate risk. As interest rates rise, bond prices usually fall, and vice versa. Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

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**Merger Arbitrage and Event-Driven Strategies**

When a company (acquirer) seeks to acquire another company (target), it typically needs to pay a premium over the target's unaffected share price. This premium is necessary because a target company's board of directors is only likely to recommend the acquisition of the company if the acquisition price is sufficiently higher than the current share price, otherwise the risk and effort of a deal isn't worthwhile. Merger arbitrage is an investment strategy that capitalizes on the spread between a company's current share price and the consideration paid for its acquisition in the context of an announced merger transaction. The merger arbitrageur seeks to profit from buying a takeover stock at a discount to its acquisition price. Proposed transactions may not be consummated for a variety of reasons, including financial, corporate, legal, and regulatory considerations. Should a proposed transactions not take place loses the position in the takeover stock will typically lead to a loss.

Indices are unmanaged, hypothetical portfolios of securities that are often used as a benchmark in evaluating the relative performance of a particular investment. An index should only be compared with a mandate that has a similar investment objective. An index is not available for direct investment, and does not reflect any of the costs associated with buying and selling individual securities or management fees. The HFRI Index is comprised of hedge funds employing a merger arbitrage strategy. Hedge funds are private funds that are more speculative than more traditional investments such as equities and mutual funds in which only investors meeting certain suitability requirements may invest. 3637026.1