

A Strategy For Erratic Markets: Event Driven and Pentwater Capital.

In these treacherous times the degree of macro risk in markets is substantial and it is tempting to try to capture these opportunities. The confident macro trader will certainly argue for the opportunity while the fundamental investor may be confounded by factors beyond their considerations. One of the more controlled ways of investing in the current environment is event driven strategies.

The current environment is characterized by weak or erratic economic growth, poor sovereign balance sheets, disparity of financial strength and commercial prospects across businesses, policy risk, political risk, and liquidity risk, to name but a few. The macro or fundamental investor is well advised to assume the specific risks they seek and to avoid or hedge the risks they do not. The event driven manager is already predisposed to this approach in the best of times and is well positioned for these erratic markets.

The current climate is certainly fertile for event driven trading. Businesses of varying financial strength make for interesting and active mergers and acquisitions. The strong have the wherewithal and currency for acquisitions, while the weak are motivated sellers or targets.

Private equity LBO activity is conspicuously quiet, yet strategic transactions continue to take place. Post 2008 PE funds continue to struggle at raising capital in the traditional buyout space and many GPs have turned to high yield, direct lending, distressed debt, and structured credit secondaries. The result for M&A is better quality and less highly levered transactions.

The differing fortunes of countries and regions encourage cross border deals with their concomitant complexity, not least from the political angle.

The difficult operating environment is also prompting balance sheet reorganizations (to stave off defaults or hostile takeovers) and defaults. The current environment encourages asset divestitures and capital raisings. In the case of default and or

reorganizations, distress investment opportunities present themselves, for example in buying fulcrum securities or providing debtor in possession financing.

Event driven investing is a perennial strategy which excels in hard times and coasts comfortably in good times. The key is selecting a manager with the requisite skills. Unlike macro and fundamental investing, event driven managers require not only investment and trading skills but legal, regulatory, and strategic skills as well.

The garden variety event driven manager assesses the terminal prospects for an event. The textbook risk arbitrage trade is highly levered and has negatively skewed returns meaning that success is rewarded slightly and failure is punished acutely. However, by assessing the probability of deal break, or deal completion, and diversifying over a number of deals, a positive expected return can be achieved. Better managers assess the evolution of an event so that no information is left to waste. Combined with option strategies, path dependent trades can capture more returns per event while correcting for the negative skewness of the vanilla trade. For the most part, merger arbitrage is expressed in the equity of the companies in play. There is no reason why the same event cannot be capitalized upon in the debt of the relevant companies. Some mergers feature unlisted companies which almost always have debt securities. Differential treatment of claims under change of control can cause different claims to price differently creating arbitrage or trading opportunities. Few managers have cross capital structure expertise to take advantage of these situations. Managers able to trade in the credits benefit from participating in less crowded trades.

Some managers may even play an active part in steering an event to their preferred outcome. All the good managers assume only the risks they want and hedge out or avoid the risks they don't want. They may hedge each event or situation individually or they may use portfolio hedges (which are a bit of a blunt instrument.)

There are many event driven managers in the industry, but there are very few with the full set of skills to capitalize on the opportunities and to manage the risks as comprehensively as described.

One such manager is based in Chicago and has printed an unparalleled track record...
Pentwater Capital Management.