

# Schroders FundFocus



## Schroder GAIA Paulson Merger Arbitrage

Schroders has teamed up with Paulson & Co to offer a fund exploiting the gains to be made from merger arbitrage. We spoke to John Paulson, manager of Schroder GAIA Paulson Merger Arbitrage, to find out how this fund can provide diversification benefits to a portfolio.

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### Could you tell us a bit about Paulson & Co and the team involved with this fund?

I founded Paulson & Co in 1994. Since then, my team and I have built the firm's investment capabilities and infrastructure so that today it has approximately \$14 billion<sup>1</sup> under management. We now employ 133 people in New York, London and Hong Kong<sup>1</sup>.

All our strategies are based on the same underlying investment philosophy and objectives: preservation of capital, above average returns, low volatility and limited correlation to the broader markets. Paulson & Co. employees, including myself, are the largest category of investors in our funds. As an organisation, Paulson & Co. relies on the entrepreneurial spirit of its employees and encourages teamwork. The firm is a partnership, which helps foster the highest degree of alignment between ourselves and our investors.

I am the portfolio manager for all the funds but am supported by a team of 52 investment professionals<sup>1</sup>, both sector and transaction specialists, who contribute to the management of the funds. Andrew Hoine and Jim Hoffman are co-managers of the funds, and each have over 20 years' experience in the merger business.

### What is special about this fund?

The merger arbitrage funds are our oldest and largest and with \$7 billion under management, they represent approximately 51% of our total assets<sup>1</sup>. They have a proven, 22 year track record of delivering strong performance from a diverse set of merger-related opportunities. These include exploiting price spreads between bidder and target, topping bids, liquidations, bankruptcy

reorganisations, pre-announced deals and exchange offers, and this broad approach provides opportunities in all types of market conditions. Schroder GAIA Paulson Merger Arbitrage forms a part of this offering and specifically benefits from:

1. Depth of experience within the investment team
2. Clear expertise and competitive edge
3. A unique, clearly defined strategy that has produced uncorrelated returns over 22 years.

### What is the fund's investment universe?

The fund only invests in opportunities where we believe we have a definitive edge, with a primary focus on North America and Europe.

The strategy is not constrained to using specific instruments or securities and we use all types of publicly traded securities. In practice this is mainly equities and bonds, however, selectively we also use over-the-counter instruments, options, swaps (including credit default swaps) and other derivatives.

### How do you generate new ideas?

Investment opportunities are sourced from a number of channels, including newsflow and trade publications, as well as our relationships with sell-side institutions, industry contacts and the professional network of our investment team.

### What is the investment process then?

Our investment professionals are specialists, either in particular sectors and industries or in specific functions, such as transactions, regulation, banking or accountancy. Given that event-driven opportunities do not recur

frequently, they are difficult and expensive for most investors to research effectively. We attempt to exploit this "informational inefficiency" by using our specialist expertise to undertake detailed fundamental bottom-up analysis to develop a full understanding of the risks and rewards surrounding such events.

When an analyst identifies a potential opportunity, he or she will perform an initial analysis of the company, its industry, peers, the expected event, and then present their findings to the Head of Research and the portfolio manager. An intense review of the analysis follows and, if initially attractive to the portfolio manager, this typically results in a request for further investigation. Subsequent to this and further discussion, a decision to invest may be made. During this stage of the process, the analyst team is also asked to come up with ideas to hedge the position. This typically involves collaboration between the portfolio manager and the analyst team, with a focus on market, sector and company specific risk. Approximately 75% of our research is carried out internally.

### How do you construct the portfolio?

The initial focus when structuring the portfolio is on what we believe will be low risk/high return deals. Each possible opportunity is scrutinised and ranked based on risk. Focusing on the low-risk end of the pool, we review return characteristics and choose what we believe to be the best risk-adjusted return deals for the portfolio.

Deals with the best risk-adjusted return characteristics will receive higher weightings (up to a maximum of 10% – the position limit set by UCITS regulations). The portfolio typically comprises 30 to 60 positions, and



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is diversified by geography and by sector. The top 10 positions will typically represent between 20 to 40% of the portfolio. The majority of the positions in the portfolio are invested in companies with large market capitalisations.

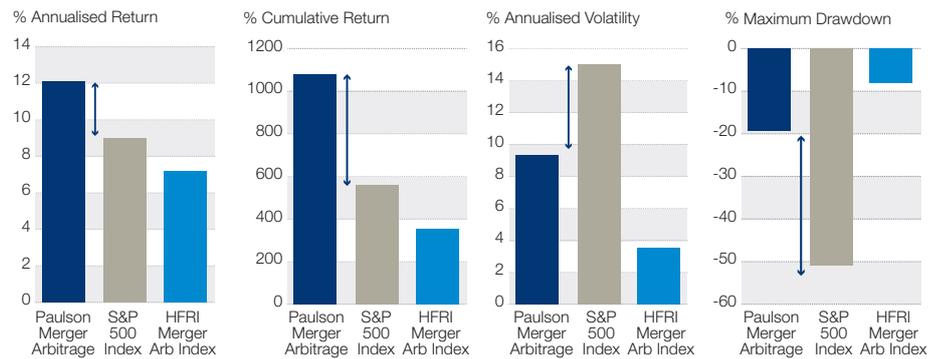
**Managing risk in the portfolio is clearly very important. What is your approach?**

The primary objectives of the fund are capital preservation, low correlation to broader markets, and minimal downside volatility. We use various direct and market hedges to minimise market correlation and drawdowns. Furthermore, we carefully examine the potential for, and probability of, upside and downside risks in a transaction. In doing so, we eliminate upfront the riskier arbitrage transactions, which over time have proven to have a poor, or even negative, expected value. The initial position sizes are determined so that the potential downside does not exceed 2% of net asset value.

Furthermore, we look for deals whose characteristics imply a high probability of closing. Our focus is on strategic combinations of solidly performing targets by large acquirers. This increases the probability that deals in the portfolio will close in most market environments.

We also size individual positions according to their potential downside, the probability of that downside, the potential upside, the probability of that upside, and the probability of the deal collapsing. We have developed a proprietary internal risk management system to suit our needs. Additionally, we use external service providers such as Riskmetrics.

Figure 1: Significant alpha with less volatility since July 1994



Source: Paulson & Co. and Schroders as at 29 February 2016.

The chief risk officer provides the portfolio manager with a regular package of proprietary risk reports summarising portfolio risk statistics and risk concentrations. Ad-hoc requests are also prepared as needed by the portfolio manager.

**Why should investors consider a merger arbitrage strategy?**

There are three main reasons to invest in merger arbitrage strategies. Firstly the strategy offers an attractive risk/return profile. On a 20 year basis, merger arbitrage strategies have outperformed the S&P 500 with considerably lower volatility than many equity indices (see Figure 1 above). Secondly, the strategy has provided capital preservation in down markets. During periods of market stress, merger arbitrage returns have suffered far less than broad equity indices. The average negative month's return is significantly less than equity indices and, importantly, down

months have been far less frequent. Lastly, it exhibits a low correlation to the broader market. Returns for the strategy are based on a manager's ability to evaluate deals rather than the direction of the market. Opportunities exist throughout the economic cycle, as the strategy is able to short deals and exploit bankruptcy situations. It is therefore a valuable diversifier of returns and dampener of volatility within a broader portfolio.

**What persuaded you to partner with Schroders?**

Having successfully managed this strategy for 22 years, we wanted to extend it to a wider audience using a UCITS platform. Schroders has a tremendous reputation in this area, with one of the leading alternative UCITS distribution platforms. We see significant opportunities in merger arbitrage and are excited about developing them further in our partnership with Schroders.

Performance Summary – periods to 29 February 2016

| Performance in USD %                    | 3 months | 1 year | Since inception <sup>1</sup> |
|---|----------|--------|------------------------------|
| Schroder Paulson Merger Arbitrage C Acc | -6.1     | -15.0  | -17.5                        |

Source: Schroders, C Acc class, NAV to NAV basis, net income reinvested.

1 Launch date 25 June 2014.

Fund manager biography

**John Paulson** is President of Paulson & Co, specialising in mergers and acquisitions. Before setting up Paulson & Co, he was a general partner at Gruss Partners for four years, and before that Managing Director, Mergers and Acquisitions at Bear Stearns for four years. John holds an MBA from Harvard Business School and was made a Baker Scholar, Harvard's highest honour, in 1980. John also has a Bachelor of Science, summa cum laude, in Finance from New York University, where he was elected Valedictorian. John serves on the Board of Trustees of New York University; Board of Trustees of the Central Park Conservancy; Board of Trustees of the Metropolitan Museum of Art; Deans Advisory Board of the Harvard Business School; the Board of Directors of the 92nd Street Y and the Board of the Partnership for New York City.

**John Paulson – President of Paulson & Co.**

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