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Pre-Merger SPACs: A Replacement for M&A Arbitrage Funds

Tuttle Capital Management

Abstract

Financial advisors will often look to diversify a portfolio through funds and ETFs that do not correlate with the rest of a client's portfolio. One alternative asset class they may pursue is an event driven strategy, merger and acquisition (M&A) arbitrage. However, this paper serves to demonstrate how a well-managed grouping of pre-merger Special Purpose Acquisition Vehicle (SPAC) shares could replace and improve on M&A arbitrage funds as a part of a portfolio through pre-merger SPACs' risk and potential reward characteristics.

Introduction

A common goal for most advisors is seeking steady preservation and growth of capital for clients. M&A arbitrage funds have been touted as a means to produce gains with small downside. After the COVID-19-induced stock market crash in late February 2020, an alternative strategy has emerged stemming from pre-merger SPACs. The asset allocation in this case would be to a broad range of well managed pre-merger SPACs, whereby a portfolio manager buys pre-merger SPAC shares trading below $9.80 and rebalances (weekly, in the case of our backtest) the pre-merger SPAC shares that exceed $9.80 to generate gains, with better downside protection than M&A arbitrage funds.

Problem

The market crash during the initial stage of the COVID pandemic illustrates the issue with asset allocation into an alternative asset class of M&A arbitrage funds. The purpose of M&A arbitrage funds is to mitigate risk through low correlation to the broader market, which will be touched on later. But looking at an M&A arbitrage fund over the period of 2/21/20-3/23/20 (COVID market crash), The Merger Fund Investor Class (MERFX), dropped 6.99%[1]. The largest M&A arbitrage ETF, IQ Merger Arbitrage ETF (MNA), experienced a decline of 27.11%[1]. Additionally, the S&P 500 Index was down 33% for this period, further illustrating the downward spiral the market experienced during this period[1]. MNA as an alternative asset class to an ETF like SPY or VOO would not have aided much in portfolio downside protection. MERFX would have provided better downside protection as a more conservative fund, but at the cost of gains illustrated later. Furthermore, if inflation is rising and not transitory, and while central banks continue to inject liquidity into the markets and are running out of options on setting interest rates, a correction or longer lasting bear market needs to be on advisors' minds.

Solution

Advisors can turn to the ever-growing SPAC sector as an alternative portfolio allocation for possible better overall results compared to M&A arbitrage funds. A managed pre-merger SPAC fund that purchased shares of every SPAC below $9.80 and rebalanced weekly by selling when a SPAC exceeded $9.80, would have only experienced a downturn of 2% during the period of 2/21/20-3/23/20, which would have protected a portfolio by 4% more than the nearest M&A arbitrage fund MERFX, 25.11% more than MNA, and 31% greater than the market[1]. Starting from 2/1/20, the recent vintage for SPACs, the pre-merger SPAC strategy would generate a return of 11.53% up until 7/13/21[1]. From the same starting point, the S&P 500 has produced a gain of 34.52%, MNA 21%, and MERFX 3.25%[1]. While returns for the former two are more pronounced, what has been shown concerning the pre-merger SPAC strategy is capital preservation, with a higher return than the conservative MERFX. Assuming advisors and their clients would not have sold during this large downturn, on a speculative basis, seems unlikely faced with the uncertainty during COVID. As opposed to a 2% decline from the pre-merger SPAC strategy which would not be as alarming as the figures for the other funds shown above. Continuing from 2/1/20, compared to the S&P 500, the pre-merger SPAC strategy has a correlation of 0.11[1], MNA 0.67[2], and MERFX 0.74[2]. That is a wide disparity in correlation with the S&P 500 and shows how the pre-merger SPAC strategy would be better suited as an alternative asset class in a portfolio than M&A arbitrage. Furthermore, dating back 1 year from 7/13/2020, the pre-merger SPAC strategy had a standard deviation of 4.22, as opposed to 10.46 for MNA, and 2.84 for MERFX[1]. This demonstrates how the pre-merger SPAC strategy is a medium to replace the low risk and reward of MERFX and high risk and reward of MNA. Keep in mind that the pre-merger SPAC strategy example was based purely on price and doesn't take into account the SPAC management team and their track record.

Summary

Based off this sample event (COVID), the pre-merger SPAC strategy provides more downside protection, while still providing a valid return during normal US Equity market conditions. However, until another correction or bear market, the validity of the strategy cannot be more fully tested. For now, though, it could be a worthwhile addition as a small allocation to a portfolio, if managed properly.

1 Bloomberg, backtested 7/13/21

2 https://www.sectorspdr.com/sectorspdr/tools/correlation-tracker/multiple-securities

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