Schroders FundFocus

Schroder GAIA Paulson Merger Arbitrage

Schroders has teamed up with Paulson & Co to launch 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 newly-launched fund can help investors generate above average returns with low volatility and limited market correlation.

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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 $22 billion dollars under management*. We now employ 125 people in New York, London and Hong Kong.

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 broad 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 54 investment professionals, both sector and transaction specialists, who contribute to the management of the funds. Andrew Hoine, who joined the firm in 1998, and Jim Hoffman each have over 20 years experience in the merger business and are co-managers of the funds.

*as at 1 March 2014.

What is special about this fund?
The merger arbitrage funds are our oldest and largest and with $8 billion under management, they represent approximately 35% of our total assets. They have a proven, twenty-year track record of generally delivering strong performance from a diverse set of merger-related opportunities. These opportunities include exploiting price spreads between bidder and target, topping bids, liquidations, bankruptcy reorganisations, pre-announced deals and exchange offers. Schroder GAIA Paulson Merger Arbitrage now forms a part of these funds and specifically offers:

- Depth of experience within the investment team
- Clear expertise and competitive edge
- A unique, clearly defined strategy that has produced uncorrelated returns over 20 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. We use all types of publicly traded securities – mainly equities and bonds, however selectively also use over the counter instruments, options, swaps (including credit default swaps) and other derivatives.

How do you generate new ideas and what is your investment process?
Our investment professionals are specialists, either in particular sectors and industries or in specific functions, such as transactions, regulation, banking and 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 portfolio manager. This then involves an intense review of the analysis and, if initially attractive to the portfolio manager, 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.

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

How will the portfolio be structured?
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.

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*Schroder International Selection Fund is referred to as Schroder ISF throughout this document.

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, diversified geographically, by sector and by instrument type. The top 10 positions will typically represent between 40%-60% of the portfolio. The majority of the positions in the portfolio are invested in companies with large market capitalisations.

How do you manage risk in the portfolio?

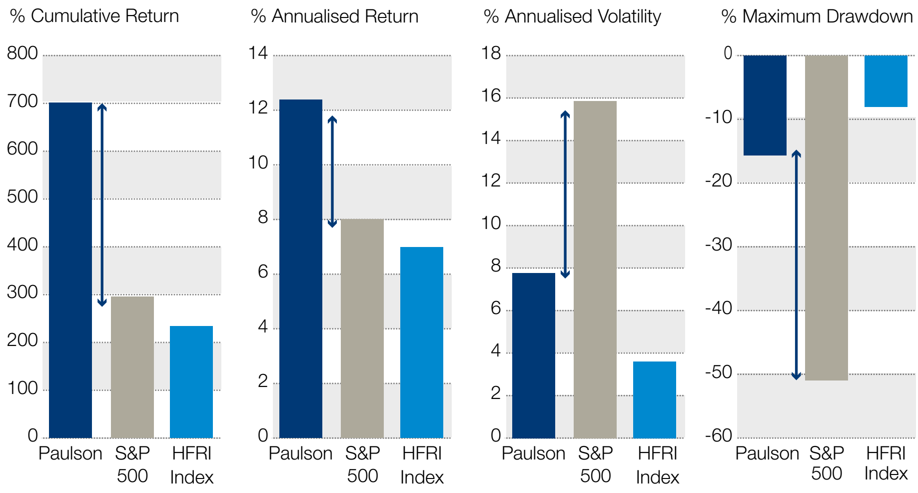
The primary objectives of the fund are capital preservation, low correlation to the broad markets and minimal downside volatility. We use various direct and market hedges to minimise market correlation and drawdowns. Furthermore, we carefully examine the potential for and probability of upside and downside in a transaction. In doing so we eliminate up front 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.

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 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.

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.

Significant alpha with less volatility since inception



Source: Paulson & Co. and Schroders as at 31 March 2014.

What persuaded you to partner with Schroders?

Having successfully managed this strategy for 20 years, we wanted to extend it to a wider audience using a UCITS format. Schroders has a tremendous reputation in this area, with one of the leading UCITS distribution platforms in alternatives investment. We see significant opportunities in merger arbitrage and are excited about developing them further in our new partnership with Schroders.

Why is now a good time to invest in a merger arbitrage strategy?

Many people think that merger arbitrage is just about capturing merger arbitrage spreads, but our approach uses a much broader definition which gives us the opportunity to make money in many different market environments. However, global merger and acquisition activity is currently very healthy with over $400 billion of deals announced in April 2014 alone, the highest monthly level for over five years, and this provides a tailwind to our strategy. Global merger and acquisition activity continues at stable levels, averaging $650 billion of announced deals a quarter ($2.6 trillion annualised). In general, annualised returns in spread deals are not highly attractive, ranging between 4% and 7%. However, while spreads remain tight in plain vanilla deals, complex deal structures, competitive bids, and pre-announced deals offer scope to generate higher risk-adjusted returns.

Our approach enables us to obtain these higher returns by investing in diverse risk arbitrage, merger and event opportunities. Given the very large (and growing) market opportunity for these merger arbitrage deals, we believe the fund will continue to be successful.

Fund Managers Biography – John Paulson

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.