Maxam Arbitrage Fund – Q2 2022 Commentary

Dear fellow investors,

The Maxam Arbitrage Fund[1] declined -0.6% in the second quarter of 2022, in what was a very challenging period for both equities and bonds.

The fund has held up very well during the market correction – demonstrating its value as an alternative source of returns and a portfolio diversifier. Over the last 12 months the fund gained +2.2% whereas the iShares Core CAD Universe Bond ETF declined -11.7%[2].

Merger and SPAC arbitrage yields are attractive right now, presenting investors with an opportunity to earn returns from a strategy that is uncorrelated with traditional equities and bonds.

	June 2022	Q2 2022	YTD 2022
Maxam Arbitrage Fund[1]	-0.1%	-0.6%	-0.3%
S&P/TSX Composite	-9.0%	-13.8%	-11.1%
S&P/TSX Small Cap	-13.6%	-21.2%	-15.0%
S&P 500	-8.4%	-16.4%	-20.6%
NASDAQ	-8.7%	-22.4%	-29.5%
MSCI World	-7.9%	-14.8%	-19.0%
iShares Core CAD Universe Bond Index ETF	-2.2%	-5.7%	-12.4%
Vanguard Total Bond Market ETF	-1.7%	-4.8%	-10.3%

Source: Maxam, Bloomberg.

State of the arb market.

The overall market narrative continues to be dominated by high inflation, rising interest rates, fears of a recession and geopolitical tensions.

Arbitrage spreads widened during the quarter to levels not seen since the Covid crash in March-April 2020. In addition to tracking the broad risk-off environment, spreads were pressured by a more expensive and difficult market for high yield financings and leveraged loans.

In particular, yields on leveraged buyout transactions widened in early June when reputable private equity firm Thoma Bravo announced that they had renegotiated and reduced the price they had agreed to pay for Anaplan Inc. from $66.00 to $63.75 per share. This deal re-price remains a ‘one-off’ at time of writing with other notable leveraged buyout transactions recently closing on terms.

Also continuing to impact arbitrage spreads and deal timelines is the increased scrutiny that U.S. regulators are applying to mega-cap deals and companies in industries deemed more sensitive to competition issues.

Despite a challenging market environment, new deal announcements continued to be plentiful during the second quarter, providing us with a robust opportunity set to take advantage of. However, while it is difficult to forecast future deal activity, we are mindful that the present risk-off nature of the markets coupled with rising interest rates and wider credit spreads may be a headwind.

Constructively, market volatility and lower valuations will lead to new opportunities for dealmakers as companies look to make strategic acquisitions and position themselves for future growth. And private equity firms have significant amounts of capital that needs to be deployed which may help temper any slowdown.

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Nimble.

Being nimble is an advantage in terms of both seeking returns and managing risk. We enjoy the flexibility and advantage of investing across the capitalization spectrum, providing us with a larger opportunity set. While every merger deal is different, we look favourably on mid and smaller capitalization transactions in the current environment because regulatory risks are typically lower, and the deal timelines are shorter.

Regardless of deal size, we are always focused on transactions that we believe will reach successful completion.

The fund invested in 15 new deals during the quarter, had 14 successful deal closures and experienced no deal breaks (although we did own the Anaplan re-price). As of June 30, the fund held 35 merger arbitrage positions, diversified across market cap, deal type and industry.

Owned deals that successfully closed during the quarter included[3]: Cerner Corp; Ferro Corp; IntriCon Corporation; Intertape Polymer Group; Noront Resources; Anaplan Inc; Questex Gold & Copper Ltd; SOC Telemed Inc; Veoneer Inc; and Intersect ENT, Inc.

Some notable new positions initiated during the second quarter included[3]: Covetrus Inc; FAX Capital Corp; GTY Technology Holdings; Points International; Redline Communications; and Sailpoint Technologies.

SPAC yields rise.

Just as traditional IPOs are less likely to come to market during unfavourable market conditions, so too are SPACs. New SPAC issuance continued to slow during the second quarter with less than 20 new SPAC listings, a steep drop from the 54 seen in the first quarter of 2022[4] (and a far cry from the pace of more than 600 in calendar 2021).

In addition to the weaker market environment, the SEC's proposed new, and more stringent, rules for SPACs (discussed in our Q1 commentary) are likely making it more difficult for SPAC sponsors to find and consummate deals. SPAC redemption rates, where investors elect to redeem their SPAC shares for the cash held in trust, continued to be high at approximately 80%, during the second quarter[4].

A high rate of SPAC redemptions makes it very difficult for investors who bank merely on upside from well-received deal announcements, or for those who speculate on SPAC warrants - which will expire worthless if a deal is not completed. We continue to take a very conservative approach to SPAC warrants, routinely harvesting them post unit split, rather than hoping a deal the market likes will be completed.

From a SPAC arbitrage perspective, the risk-off environment and still well-supplied market with almost 600 SPACs currently seeking acquisitions[5] provides us with a very attractive reward-to-risk set-up. SPACs are trading at unlevered annualized yields near 5% on average[6] – a return that is backed by short-term government securities (i.e. T-bills) held in trust.

We also note the *SPAC cliff* on the horizon - almost 95% of listed SPACs are due to liquidate within the next 12 months[7], presenting us with an attractive set-up for our systematic and quantitative approach to harvesting SPAC yields.

As of June 30, the fund was well-diversified across 158 SPACs, and we are currently deploying capital at attractive yields.

Looking ahead.

Merger and SPAC arbitrage yields are attractive right now, presenting investors with an opportunity to earn returns from a strategy that is uncorrelated with traditional equities and bonds.

Arbitrage is an attractive strategy for the long-term, and its unique characteristics make it a particularly attractive strategy in the current environment. Rising interest rates are a clear negative for bonds, however they can act as a tailwind for arbitrage because of the low duration nature of the strategy – deals typically complete in just a few months.

In addition to providing a compelling alternative to bonds as interest rates rise, arbitrage strategies also provide excellent diversification to traditional equity market exposure because returns are generated from the successful completion of specific and definitive corporate events. As arbitrageurs we expect to profit regardless of the behaviour and direction of the stock market.

Risk management is central to our quantitative, data-centric and disciplined investment process as we deploy capital into a robust and attractive opportunity set.

Thank you for your trust and confidence. Please don't hesitate to reach out with any questions.

Sincerely,

Travis Dowle, CFA
President & Fund Manager
Maxam Capital Management Ltd.

[1] Maxam Arbitrage Fund, Class F, net of fees and expenses. Inception date October 1, 2020. Please contact us regarding other series of fund units or visit our website www.maxamcm.com

[2] iShares Core CAD Universe Bond ETF, ticker XBB.

[3] Notable owned deals successfully closing during the quarter is not an exhaustive list. New positions initiated during the second quarter is not an exhaustive list.

[4] SPAC statistics sourced from: Maxam internal database and https://icrinc.com/insights/icr-q2-2022-spac-market-update/

[5] https://www.spacanalytics.com/

[6] Maxam internal database and https://spacinsider.com/stats/

[7] Maxam internal database.