A Discussion with Heather E. Tookes, PhD

Heather E. Tookes is a professor of finance at the Yale School of Management whose research lies at the intersection of capital markets and corporate finance. She is interested in the ways in which capital market frictions can impact market outcomes. A primary theme in her work is the structure of liquidity and efficiency externalities (how trading in one market affects liquidity and price formation in related markets), with a particular focus on credit and credit-linked derivatives. She teaches the corporate finance elective in both the full-time MBA and the MBA for Executives programs. She earned a PhD in finance at Cornell University and a BA in economics from Brown University.

Professor Tookes spoke at IMCA’s 2015 Summer Institute powered by Yale University. Following the presentation, Tony Davidow sat down with her to talk about alternative investment strategies.

Davidow: Great discussion today on alternative investments. One of the challenges for advisors is understanding how to distinguish among the different types of alternative investment strategies. There is often a tendency to group all of these alternative strategies together. Yet there is a great deal of diversification across the various types of alternative strategies. These strategies respond differently to market conditions and seek to exploit different opportunities.

Can you start by talking broadly about alternative investments and share some of your research? Also, can you distinguish among the various types of alternatives?

Tookes: There is significant variation, even within a given strategy, in terms of how managers are looking to generate returns. Today, I discussed two broad categories: convertible-bond arbitrage and event-driven arbitrage. Both of these often involve taking both long and short positions and are very different from, for example, dedicated short strategies where the market exposure is essentially negative. During my discussion, I highlighted differences in what happened during the crisis. In convertible-bond arbitrage, we saw a huge decline in value in 2008, followed by a recovery. For a dedicated short we saw essentially the reverse. If one is thinking about adding a particular strategy to one’s portfolio, it’s important to understand not only the potential alpha, but also the beta and whether the beta varies during downturns.

Davidow: One of the things that I certainly heard a lot of back in 2008 was “These strategies really didn’t protect me in the downturn.” Obviously, some of the alternative strategies did better than others—and most lost less than the S&P 500. Managed futures were a positive standout in 2008. Strategies such as managed futures and global macro historically have delivered low to negative correlation to equities, while others such as long/short, market-neutral, and event-driven have exhibited higher equity correlations.

One of the things that would help our advisors is some guidance regarding diversification across alternative strategies. Can you address diversification?

Tookes: The correlation in performance was certainly not perfect across these strategies. One thing that I think is important to highlight when one is thinking about taking advantage of the imperfect correlation across these strategies is that correlations can vary with market conditions. During the crisis, some strategies became much more correlated with both the market and each other.

Davidow: Let’s go a little deeper in discussing a few of these strategies. Let’s focus on convertible arbitrage and event-driven. Please describe what the strategy is designed to do and describe how they generate excess returns over time.

Tookes: Convertible-bond arbitrage offers returns that are on average lower than that of the market. During 1996 to 2014, we saw returns to convertible-bond arbitrage that were around 6 percent. These returns were lower than that of the S&P 500, but with relatively low correlation with the market—lower than the correlation that one would get via a traditional 60-percent stock/40-percent bond portfolio.

Convertible-bond arbitrage often takes advantage of the fact that at issue—i.e., when firms decide to issue new convertible debt—those debt issues are underpriced. Essentially, convertible-bond arbitrageurs are providing liquidity to firms that need capital now and get a liquidity premium in return for doing that. We do see that the estimated alpha to the strategy can be significant. Those returns are largely for that liquidity provision.

Davidow: Let’s talk a little bit about event-driven and specifically merger-arbitrage—which, as you point out, is one of the oldest strategies and probably one of the easiest to understand. Walk us through a transaction. I thought you did a super job today talking...
about the expectation of the acquirer, how these strategies are priced in the market, where the returns are generated.

**Tookes:** Merger arbitrage, as you say, is an old conventional arbitrage strategy where typically the arbitrageur will take a long position in the target stock upon announcement of a potential takeover. They do that because the target stock prices tend to increase upon announcement of a deal, but not all the way to the offer price. Part of the difference between the offer price and the target stock price—the arbitrage spread—comes from the possibility that the deal isn’t going to go through. The liquidity needs of target shareholders also drive some of that discount. Target shareholders oftentimes don’t want to be in the market, don’t want to hold event risk, and would like to exit those shares sooner than later. In return for liquidity, arbitrageurs can gain attractive returns. The estimated Sharpe ratios on event-driven arbitrage are even higher than convertible-bond arbitrage. But there are risks.

I walked through an example of a friendly deal, which tends to be more likely to complete than others. The deal offered potential value to both acquiring and target shareholders. And based on a reasonable analysis of the deal, one might expect that that particular deal would go through. Unfortunately for the arbitrageurs who decided to take advantage of what was almost a 4-percent arbitrage spread, which is quite attractive, especially these days, the deal did not go through. In fact, the deal failed and the acquirer was taken over by another company—a worst-case outcome. In classic merger arbitrage, when it’s a stock deal, the arbitrageur will take the long position in the target and a short position in the acquirer. By having this deal fail because of a new competing bid for the acquirer, the losses were magnified.

That example shows how important it is to understand the economics of the deal and calculate the probabilities that a deal will fail. It also highlights the factors that drive the returns to merger arbitrage—both deal-specific and market risks. I tried to emphasize the market risks during today’s discussion. One of the important considerations for event-driven arbitrage is that it is more sensitive to market downturns than, for example, convertible-bond arbitrage. That’s because the amount of deal-making is really sensitive to economic conditions.

**Davidow:** One of the things you touched on today is the dependency on the amount of investments coming through the market. Convertible-arbitrage strategies are dependent on the number of convertible bonds available in the marketplace, and event-driven strategies are dependent upon merger and acquisition activities and other structural changes. Is this a good market for these types of strategies? Is this a better market for a particular type of strategy?

**Tookes:** One of the punchlines from my presentation, both in terms of convertible-bond arbitrage as well as event-driven strategies, is that it’s important to understand the supply and demand factors in the market. If I’m going to invest in convertible bonds in a given time period, it’s useful to know whether convertible-bond arbitrage hedge funds as a group have recently received inflows of capital. When a lot of money is available to firms, they’re able to offer convertible bonds at terms that are more favorable to them. It’s important to understand whether you’re in a supply-driven or a demand-driven market.

There is a very close relationship between convertible-bond arbitrageurs and issuing firms. You see that issuance occurs in lockstep with flows into convertible-bond arbitrage hedge funds. So trying to distinguish between demand-driven and supply-driven conditions can inform investment.

**Davidow:** Thank you for your insights. I think our readers should benefit from your research and perspective.

Anthony B. Davidow, CIMA®, is vice president, alternative beta and asset allocation strategist, with the Schwab Center for Financial Research. He has served on IMCA’s board of directors and is a member of the Investments & Wealth Monitor editorial advisory board. He earned a BBA in finance and investments from Bernard M. Baruch College. Contact him at anthony.davidow@schwab.com.