The Conservative Strategist

OCTOBER 2018

A QUARTERLY INVESTMENT NEWSLETTER PUBLISHED EXCLUSIVELY FOR CLIENTS OF SEASONAL STRATEGY

The merger boom opens an opportunity

We're living through a veritable flood of mergers, with 2018 expected to break all records, perhaps approaching $4.5 trillion. It's both a signal and an opportunity.

Signal: US Stocks offer no margin for error

Ominously, the last two times mergers approached current levels were early 2000 (remember AOL/Time Warner?) and mid-2007 (Alcoa/Alcan, Thomson/Reuters, and many others). Both merger booms coincided with major market tops and ushered in brutal bear markets.

Is history repeating? Let's put it this way: The cyclically-adjusted price/earnings ratio (known as CAPE) of US stocks has reached 33, equal to that of the 1929 top and topped only by a few months in late 1999 and early 2000. The risk/reward scenario for US Stocks today is uniformly awful.

Merger arbitrage

Is there perhaps a better way to capitalize on the merger boom? Yes, there is. Today, merger arbitrage offers a far more attractive risk/reward ratio than owning US stocks outright.

Merger arb, as it is called, is the purchase of the stock of a merger targets *after* a deal has been announced. Why after? Because after an announcement is made and the target stock pops higher, there nearly always remains a little profit in the deal. Also, the pop itself removes much of the volatility in the stock, and it tends to drift higher toward the acquisition/merger price as the proposed closure date approaches. With much of the uncertainty and volatility removed, the merger arbitrageur seeks to capture that modest but reasonably reliable profit.

Can things go wrong? Yes, the deal can take longer than expected to finalize, lowering the annualized return. Occasionally, a deal even busts over antitrust or other concerns. But things can go better than expected as well, such as an early deal closure or a bidding war over the target stock.

Why now for merger arbitrage?

Up 'til about 2015-2016, merger arb saw some lean years. The strategy depends largely on deal flow and short-term interest rates, and for years both were notably low. Spreads (the potential percentage profit in the average merger arbitrage) were skimpy, in the low single-digits. Merger arbs couldn't make much of a living after expenses. Many folded up shop.

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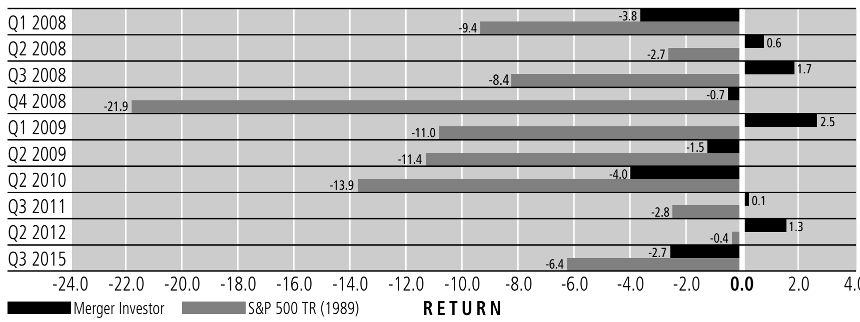
A non-directional strategy

Merger Fund performance in ten negative quarters for S&P, 2008-2015



In ten worst quarters for S&P shown, Merger was positive in five, and outperformed S&P in all ten.

Source: Westchester Capital Management

The Markets	September 28, 2018	Price/Yield	Gain, Qtr	Gain, YTD
US Stocks (S&P 500/Vanguard Index)		2913.98	7.67%	10.44%
International Stocks (Vanguard Index)		17.36	-0.44%	-4.01%
Emerging Markets Stocks (Vanguard Index)		25.99	-1.79%	-8.95%
Real Estate Stocks (Vanguard REIT Index)		26.81	7.81%	-1.89%
Bonds (30 year US Treasury/Vanguard Index)		3.19%	0.50%	0.41%
Dollar (US Dollar Index)		95.19	0.58%	3.33%
Gold (London Afternoon Fix)		$1185.40	-5.35%	-8.32%
Money Market Funds (Vanguard Prime – SEC yield)		2.13%	+0.10%	+0.77%*

*change in yield

Portfolio Planning

Two funds for the merger boom

It may be timely to add to our merger arbitrage exposure in two industry stalwarts — one helmed by a time-tested team of veterans, the other by a hedge fund superstar. Both have delivered modest but steady returns with very low correlation to our other asset classes, and even our other SuperCash categories.

Merger Fund (MERFX)

Time-tested

The first fund to establish itself in the category gets the best name, right? *Merger,* as it's called for short, is the granddaddy of all merger arb funds (which number now in the high single digits, including closed-end funds and ETFs).

From its mid-1988 inception, it has done the sector (and its investors) proud, down in just three of its 29 calendar years. Two of the three losing years have been less than 2%, and the third was just 5% and change.

The merger arb business is legal-research-intensive and so requires experience and scale. The *Merger* team has analyzed more than 4,500 deals over 30 years, building a comprehensive database that helps them to evaluate merger risk in a granular way.

And the fund's $3 billion-plus size enables it to deploy a team of 17 professionals, with lawyers and researchers combing over documents, while investment managers fine-tune trading strategy, implementation, and monitoring. All are complemented by outside legal consultants as needed for the most complex mergers.

Finally, the two principal managers eat what they cook, with seven figures each invested in *Merger.*

Merger's long-term return of 6% and change annually may seem sleepy, but it has been earned with very low risk and with valuable diversification for our clients.

BlackRock manager has extensive experience

1999 - 2002
Salomon Smith Barney
Vice President, Mergers & Acquisitions
- Advised corporated boards and their CEOs
- Over $100 billion deal experience

2004 - 2009
Caxton Associates, LP
Portfolio Manager, Event Driven Strategy
- Managed ~$2 billion

2009 - 2014
Harvard Management Co., Inc.
Co-Founder & Managing Director, Event Driven Fund
- Managed ~$1 billion

Current
BLACKROCK
Founder & Global Head of Event Driven, BlackRock Alternative Investors
- Event Driven strategy leveraging BlackRock's Collaborative Alpha

BlackRock Event-Driven manager Mark McKenna has a blue-chip pedigree. Caxton Associates was one of Wall Street's best-performing hedge funds in his years there. Harvard's endowment was a top performer in the early part of the decade as well.

BlackRock Event-Driven Institutional (BILPX)

Flexibility and risk control

If you started your own merger fund, and you could cherry-pick its manager, you couldn't do much better than Mark McKenna. His bio includes two decades of specialized merger arb experience, including heading (a) Salomon Smith Barney's arb desk, (b) the merger division of Caxton Associates, one of Wall Street's top-performing hedge funds, and (c) the event-driven wing of Harvard's endowment, which he founded. When he came to *BlackRock,* he brought much of his quant team with him from all three places. And he is aided by $5 trillion *BlackRock's* deep research resources, global contacts, and state-of-the-art technology.

Event-driven is a broader mandate than merger arb, and often riskier, since it can encompass all manner of corporate reorganizations, including spinoffs, tenders, strategic restructurings, as well as special situations such as regulatory changes, stub equities, and share class arbitrage.

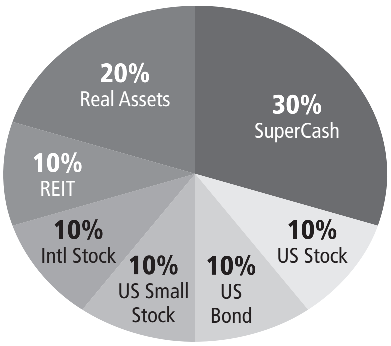
But McKenna keeps an iron grip on risk control. Since he took over the fund in May 2015 and reorganized the strategy in his first 90 days, BIPLX has suffered only four down quarters, all of them less than one percent. Currently, the bulk of his portfolio is in merger arbitrage, to capitalize on the current opportunity set of deals.

Merger and *BlackRock Event Driven* will never shoot the lights out – they're not designed to do so. But with risks rising everywhere, they offer modest returns at low risk, and portfolio diversification benefits. ■

SuperDiversified Portfolios (SDPs)

Deal flow just one sign of overheated market

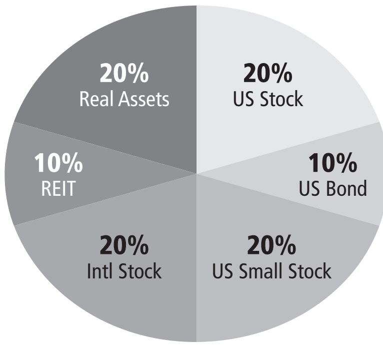
SDP1 *Conservative*



3rd Quarter **0.62%**

Year-to-Date **1.05%**

SDP2 *Moderate*



3rd Quarter **1.67%**

Year-to-Date **1.79%**

We're seeing record merger activity, just as we did in 2000 to 2007. We're also witnessing record margin debt, price/earnings ratios in the 97th percentile of their historical average, e-commerce mania, trillion dollar budget deficits, and the rollback of post-crisis regulation. All point to a market that's outgrown its host economy.

The above model portfolios are not intended to indicate the performance of any real account, but reflect the composite performance, before fees, of the percentage allocations in the asset classes and funds listed in the table below. Seasonal Strategy's actual allocations vary from these models, and among portfolios.

How the Sectors Performed

Merger Fund solid amidst rising rates

Asset Class	Mutual Fund	Performance 3rd Quarter '18	Performance Year-to-Date
SuperCash	PIMCO Instl Low Duration	0.27%	-0.16%
	Merger	-0.12%	5.65%
	Calamos Market Neutral	1.32%	3.44%
US Stock	Vanguard Index Trust 500	7.67%	10.44%
US Bond	Vanguard Long-Treasury	-3.08%	-6.23%
US Small Stock	Vanguard Small-Cap Index	4.74%	10.94%
Intl Stock	Vanguard Intl Index	-0.44%	-4.01%
REIT	Vanguard REIT Index	0.50%	0.41%
Real Assets	PIMCO Commodity Real Return	-2.33%	-2.44%

Best
Worst

Once again, merger arb is showing its mettle in a rising rate environment. The fund is up this year at roughly a 7% annualized clip, ahead of its 29-year average of 6.19%. It's also 4½ points ahead of inflation. There's a component of merger arbitrage returns that's correlated to T-Bill yields, so as short-term rates continue to lift, so should *Merger*'s prospects.

Merger ETFs... Up to snuff?

In most asset classes, exchange-traded funds, or ETFs, are an excellent alternative to open-end mutual funds. They offer index exposure, low fees, and tax-efficiency.

But what about merger arbitrage? Are there ETFs that are reasonable alternatives?

Not so much. Only two merger arb ETFs trade today, and one is tiny and illiquid.

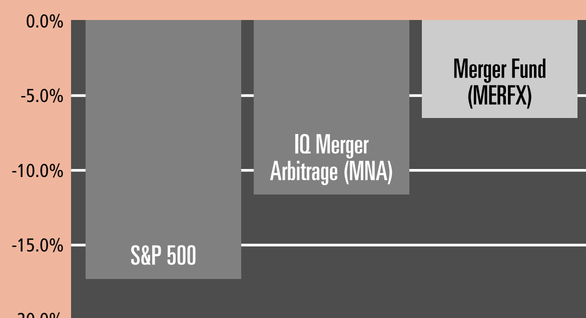
ProShares Merger ETF (MRGR), started in 2013 and due to poor performance, never attracted a following. It has less than $4 million in assets averages about 1,000 shares a day. Not an option.

IQ Merger Arbitrage ETF (MNA) is another story. Begun in November, 2009, its annual return since inception is just 4 basis points less than *Merger* (MERFX) in the same period. Liquidity is decent, at about 120,000 shares a day.

But volatility has been higher than with MERFX. In the correction of 2011, MNA took a nasty spill. It seems, for now at least, that merger arbitrage is one area where elbow grease, legal detective work, and human discretion beat computer modeling.

Stress test

Maximum drawdowns in 2011 market correction



In the deepest correction of the past nine years, Merger Fund's dip was 40% less than its ETF competitor.

SEASONAL STRATEGY

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Robert J. Gavrich
CA-Licensed Investment Adviser
President, Seasonal Strategy
1517 Fountain Street • Alameda, CA 94501

Phone 415.956.1721
Fax 415.956.1722
Email bob@seasonalstrategy.com

seasonalstrategy.com

Trump gets one right

Amidst all the havoc created by the Trump Administration, there's the occasionally shockingly reasonable proposal. One such instance: In late August, Trump issued an executive order compelling the Treasury Department to review the rules governing Required Minimum Distributions (RMDs) from retirement accounts. The Trump Administration recommended on Thursday that the age at which RMDs must be raised from age 70½ to age 75. This proposal seems overdue, for at least three reasons.

We live longer

First, we're all living longer. Since 1974, when the original IRA legislation was passed, the life expectancy of the average 65-year-old (both sexes) has increased by an estimated 4.5 years. So the suggested increase in mandatory RMD age of 4.5 years matches the longer life expectancies. Since RMDs are meant to cover remaining life needs, this only seems right.

We work longer

Second, we're working longer. Since the mid-80s, the over-55s are the only age group which exhibits steadily rising labor force participation rates. Some are working out of need, others by choice. Regardless of motivation, working past age 70 means paying taxes on two streams of income: work income and Social Security income, which must be taken by age 70. It's adding insult to also compel this cohort to take RMDs at age 70½ they may not want or need while still earning income. Doing so may only incur unnecessary taxation, and even send them into a higher tax bracket.

Conversely, raising the mandatory RMD age to 75 will allow older workers to smooth their tax burden. Another benefit of raising the mandatory RMD age is an IRA balance that's allowed to grow for 4½ more years tax-deferred, possibly resulting in 20% to 30% additional growth.

We need to tax plan

Third, the proposal allows for enhanced flexibility and control over retirement income. It gives you more time to engage in tax planning, including Roth conversions and/or selective distributions from retirement accounts.

Some may see in this proposal just another gift to the investor class. But it also rewards diligent lifetime savings, addresses that age 70 tax bump, and delivers more autonomy and choice up to taxpayers. It would be an incremental win for retirement security.

[One final outbreak of sensibility: The administration is recommending that the life expectancy tables upon which RMDs are based be updated. They are 16 years old at present, and life expectancies, as noted, have advanced considerably. Revised tables will mean slightly lower RMDs each year.] ■

Ed Slott weighs in

- Raise the mandatory RMD age to 80 — or eliminate it altogether.
- RMDs particularly onerous to working seniors.
- No one should be forced to pull money out of IRA while they're working.
- Seniors who wish to withdraw earlier can do so voluntarily.
- 70½? At the very least, eliminate the half-year nonsense. Make it 70.

Ed Slott, CPA, is one of America's foremost experts on IRAs and retirement account planning. *Source: MarketWatch*

Merger boom

(Continued from page 1)

Fast forward to 2018. Corporate tax cuts. Repatriations. Deregulation. Firms find themselves flush with cash, and with much of the growth-by-cost-cutting behind them, they are incentivized to grow by acquisition.

So mergers are booming again, but many of the arbs who kept spreads compressed have long since left the business. Abundant supply of merger deals combined with limited demand from arbitrageurs means the annualized returns of spreads on new deals are at their highest in more than a decade. ■