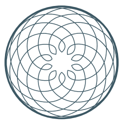

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Gabelli Merger Plus+ Trust

- **A highly-differentiated global equity portfolio run by one of the most experienced teams in the business that pursues a tried and tested merger arbitrage strategy**
- **A source of low correlation returns that offers attractive downside protection thanks to its pure focus on announced deals, with the trust also paying a healthy dividend of 5%**
- **It is a young trust whose launch on the Specialist Fund segment of the LSE last year went under the radar of most investors' DFMs, though we believe it can fulfil the needs of many income-starved investors who are concerned about the trajectory of both equity and fixed-income markets**

Summary

Gabelli Merger Plus+ is a UK-listed, closed-ended fund, pursuing a merger arbitrage strategy which has a long track record with parent company Gabelli in the United States, aiming to deliver returns which aren't correlated to equities and an attractive level of income.

The trust, which came to market in July 2017 is managed by Gabelli and is the group's second venture into the UK market following the launch of **Gabelli Value Plus+ Trust** in 2015. Gabelli has been managing merger arbitrage strategies for more than three decades and have delivered strong risk-adjusted returns over the long term. Their Gabelli Associates Fund (which follows a similar strategy to that of GMP, minus leverage) has delivered annualised returns of 7.43% since launch in 1985.

An important part of that return profile is the fund has posted less than half the annualised volatility of the index of 5.5% (compared to c.14.8% for the index) over that time. Its beta relative to the S&P 500 has been just 0.12, while its relative down market capture ratio has been 18.7%.

The team has clear value approach and focus on downside protection, as they primarily buy announced (rather than rumoured) deals. Like all Gabelli operated funds, GMP taps into the 'Private Market Value (PMV) with a CatalystTM' investment strategy, developed by founder Mario Gabelli in the 1970s, which is now taught as part of the value investing course at Columbia Business School. It is this disciplined approach (combined with the sheer size, knowledge and experience of the investment team which includes more than 20 investment professionals) that has led to the successful implementation of Gabelli's merger arbitrage strategy.

GMP's launch last year will have gone under the radar of most UK investors, given the group has done limited marketing in the UK and the shares trade on the Specialist Fund segment of the market. It has also got off to a relatively muted to start since inception in NAV terms as the portfolio was built out. However, providing the team can replicate their strong long-term, risk-adjusted returns in this new structure, we believe the trust can act as a highly attractive diversifier – particularly for investors wanting greater downside protection in their portfolios.

For example, by nature, merger arbitrage can generate returns which have low correlation to both equities and bonds. The Gabelli Associates Fund has also proven to be a useful hedge against rising rates and bond market corrections, as a we note in the performance section. Furthermore, the trust will pay an annual dividend of 5%, which may be funded out of capital and has various incentive and alignment schemes (including a stated discount control mechanism).

The task going forward will be to build up a respectable track record on the trust (this is, after all, the first time they have applied their merger arbitrage strategy using leverage) and extend Gabelli's reach within the UK market. Nevertheless, we believe this trust fulfils the needs of many income-starved investors who, understandably, are concerned about the future direction of financial markets.

Portfolio

GMP is a global equity portfolio that is highly-differentiated to other UK-listed trusts due to the fact it purely focuses on announced takeovers. Thanks to this merger arbitrage strategy, it is entirely benchmark agnostic and it means that the portfolio's returns are uncorrelated to the wider market.

The team gains exposure to merger arbitrage in two ways. The first is the simplest, as, for example, if 'Company A' announces its intention to buy 'Company B' for $100 a share (if the team likes the deal and believe it will be completed) in a cash transaction, they simply buy shares in company B and earn the spread – the difference between the takeover share price versus where the shares trade in the market. If, however, the acquirer is using a proportion of their shares to fund the deal, they 'go long' the target but short the acquirers stock respective to what the exchange ratio is to lock in the spread. The success of the strategy is entirely down to the managers picking deals that actually close, and the team therefore earning the spread between those two prices. The spread is a factor of three components - the risk-free rate, the different risk premiums that are specific to each deal (regulatory risk, financing, shareholder votes, effectively anything that could stop the deal going through), and the time value of money.

The reason returns are non-market correlated is because returns are 'deal dependent'. As such, the portfolio's returns are not reliant on on the moves in the market generally though, from time to time, certain target stocks will fall in value if there is a downturn in the wider market. At this point, the strategy might well be to top up their holdings (if they believe the deal will still close) as the spread widens. Periods of general market drawdowns are often a time when open-ended managers face outflows, one of the reasons Gabelli went down the closed-ended route for GMP (plus they can use gearing to enhance returns).

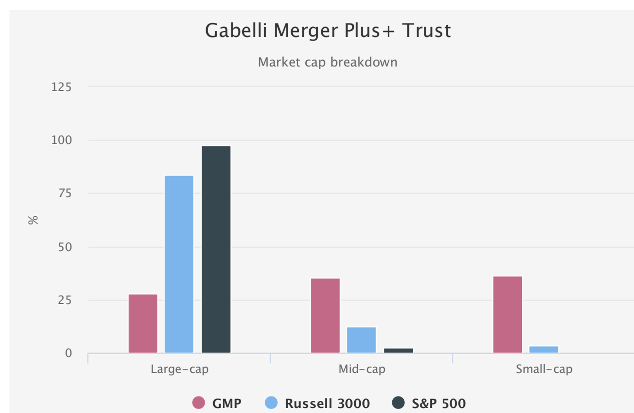
Merger Arbitrage can be highly profitable, but it all comes down to its implementation as the major risk surrounding the strategy is if the deal falls through. As such, investors need to have confidence in the underlying management team in assessing which deals are likely to complete – and Gabelli are one of the most experienced in the business. While the trust itself was only launched in July 2017, Gabelli has a long and successful merger arbitrage pedigree going back to the founding of the firm in 1977.

The investment team (led by Mario and Marc Gabelli) is comprised of more than 30 analysts, covering industry sector on a global basis. The team looks across all regions and market capitalisations for ideas. We believe this significant reach and experience in merger arbitrage (each member of the team has, on average, more than 20 years' experience) is paramount to the process and the successful implementation of the strategy, making the GMP a very attractive offering for those looking for greater diversification and down-market protection.

Like all Gabelli offerings, the team behind Gabelli Merger Plus+ follow the Private Market Value (PMV) with a Catalyst investment process, which was founded by Mario Gabelli in the 1970s and is currently taught at Columbia Business school. The process is an extension of Graham & Dodd value investing, as the team view companies from the standpoint of what their intrinsic value is to an informed buyer in a private market negotiated transaction, plus an identifiable catalyst to realise a stock's undervaluation. Ultimately, there are three key considerations involved in this process; free cashflow, earnings per share and private market value.

This is obviously the same process used by **Gabelli Value Plus+** (a predominantly US focused portfolio which we covered earlier this year), though the merger arbitrage team utilise PMV with a Catalyst to help them ascertain whether an announced deal represents good value and whether or not it is likely to close or fail as a result. This process allows the team to identify deals they consider to be mispriced. Having done so they can then then take a view on whether a deal will be rejected and on the likelihood of a higher bid, either from the original bidder or another party.

Given the major risk to a merger arbitrage strategy is if the deal breaks, a key part of the overall process is downside protection, with the team buying announced (rather than rumoured) deals and being highly selective (they tend to focus on around 5% of annual announced mergers around the world). This focus on valuation via their PMV with a Catalyst approach is paramount and the underpins their ability to protect capital. For example, when we met with Marc Gabelli recently, he noted "if we can get that part [valuation] right, we really enter into our investments with a lot of confidence".



Source: Gabelli (31.03.2018)

The trust is still relatively young and, as of March 2018, it was running with a cash balance of 7%, with the team looking for the most attractive opportunities from a risk-reward perspective. It is diversified - being made up of 108 holdings so far (the average position size is just 0.8%) and the team invest right across the market-cap spectrum, as the chart above shows.

The trust is "global" in nature, but at this stage is heavily weighted towards the US (at 95% of invested capital). Asset allocation is driven by stock selection and this weighting is driven by deal dynamics, rather than an active preference or policy. Legal

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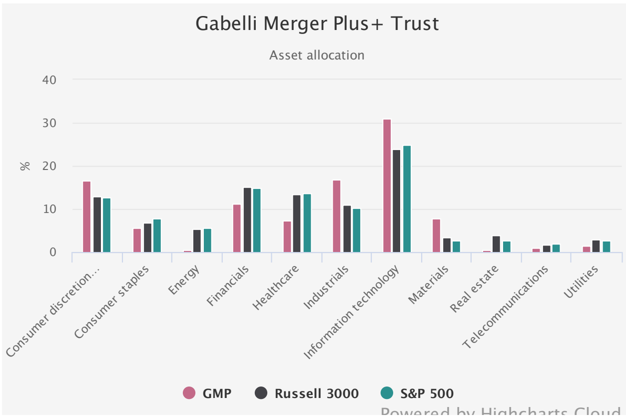
systems and regulatory environments have a major impact on regional exposure, and at present the team are finding attractive opportunities in the US in part due to Donald Trump's policies, and resurgent deal activity in the United States. We will discuss the team's outlook in the performance section.



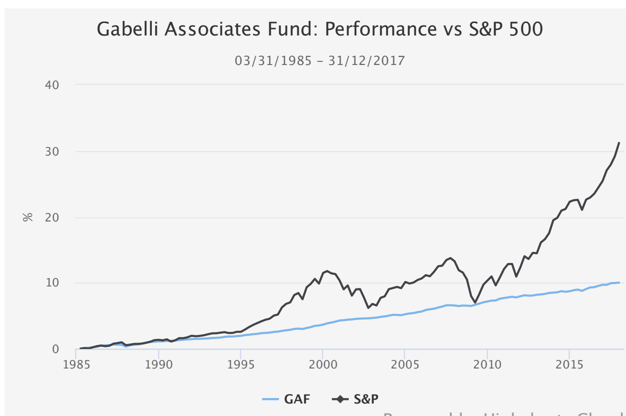
Source: Gabelli (31.03.2018)

From a sector perspective, GMP is also diversified with the largest weightings towards healthcare and consumer discretionary stocks and while the team is cognisant of its top down positioning, risk is judged on a deal by deal basis and asset allocation is the result of stock selection, rather than a conscious attempt to follow a sector or region framework.

Performance

GMP launched less than a year ago, so any review of its performance provides limited insight.

The team's focus is to deliver slow but steady returns, given that spreads are often relatively narrow. Going back to our analogy of 'Company A' buying 'Company B' at $100 a share via cash transaction, the share price of 'Company B' would likely to jump to around $98-$99 a share on the news. However, they note that as these deals will normally close over a matter of months – on an annualised basis, these small nominal returns (low single digits) can produce attractive long-term results.



Source: Gabelli

The Gabelli Associates Fund (which follows a similar strategy to that of GMP, minus leverage) has delivered annualised returns of 7.43% since launch in February 1985, and provides a solid example of the group's expertise in protecting capital.

As the chart above shows, that return profile has been remarkably smooth. In fact, over that time, the fund has posted half the annualised volatility of the index and maximum drawdown of 18% (compared to c.50% for the index). Its beta relative to the S&P 500 has been just 0.12, while its relative down market capture ratio has been 18.7%. As such, its risk-adjusted return (as measured by the Sharpe ratio) have been significantly greater than US equities over 20 years.

The strategy has posted a negative return in only two calendar years since inception in the mid-1980s and, over rolling one-year periods (priced monthly) over the past 20 years the fund has produced a positive return 96.5% of the time (compared to 74.7% for the index). Its largest one-year rolling loss over that time has been just 6.8%, whereas that figure is significantly larger for the S&P 500 at 43.8%.

RISK METRICS

NAME	VOLATILITY	MAX DRAWDOWN	SHARPE RATIO	DOWN CAPTURE RATIO*	BETA*
Gabelli Associates Fund	8.74	-18.29	1.19	18.70	0.12
S&P 500 TR USD	15.29	-48.87	0.39	100.00	1.00
Citi USBIG Treasury	10.03	-16.79	0.60	0.41	-0.09

Source: Morningstar* relative to S&P 500

The team notes how general market volatility can help the strategy, as when their holdings (which are subject to an announced merger or takeover) are caught out in a general market sell-off, their spreads widen. It is at this time the team (with the caveat that they believe the deal will go through) may 'double down' and increase their weightings. Its performance during the financial crisis is testament to this and, while the index plunged in value, the team had no deals fall through over the course of 2008. As such, the fund posted a loss of 2.4% between January 2008 and February 2009, compared to a loss of 42.3% from the index. Its returns have genuinely been lowly correlated as well, with correlation standing at 0.5 to the S&P 500 over 20 years.

Obviously, only time will tell if the team will be able to replicate this sort of return profile with GMP. However they have back-tested the strategy (including the use of leverage) and it would have delivered a compound annual growth rate of 16.7% since 1985 compared to 10.8% from the index.

Apart from an attractive source of returns with low correlation to the market and downside protection, there are various macro trends currently supporting a merger arbitrage strategy, according to Gabelli.

When we first met with Gabelli to discuss Gabelli Value Plus+ in Late 2016 (prior to the US presidential election), the team argued the world was entering a 5th wave of M&A activity, as in a world where economic growth is generally low, cash rich businesses would continue to buy growth rather than try and generate it organically. They argue this is still the case, but on top of that, there has been a so-called 'Trump' effect in the US market.

Firstly, they note how Trump is changing the regulatory landscape and the recent tax package has brought a degree of clarity towards the deployment of capital and capital allocation. They also argue, under Trump, there will be the birth of the 'national champions'. Under Trump, they have witnessed signs of policies to 'bulk-up' industries via 'horizontal mergers'. These were previously prevented under FTC rules because of concentration limits that looked at the US on its own. While Trump is clearly a protectionist in his policies, they note how he is also looking at these policies via global lenses. This means that mergers that would have never been allowed previously, might start to happen. It is early days of course, but the team note there are a number of deals on track to test this, such as the proposed acquisition of 21st Century Fox by Disney, which is a clear example of 'horizontal merger' in the team's eyes.

It is also worth noting that, while not necessarily a core part of the team's outlook, history has shown merger arbitrage can be an effective hedge against bond market sell-offs and rising rate environments. This comes back to one of the major components of a spread (the risk-free rate), meaning that when the risk-free rate (or US treasury yields) rises, spreads tend to widen. **We highlighted the potential for rising bond yields in this research** and data from Gabelli shows that, during periods when interest rates have risen in the past, the Gabelli Associates Fund has delivered considerably higher returns than US investment grade bonds.

PERFORMANCE WHEN THE US FEDERAL RESERVE HAS RAISED RATES*

NAME	1994	1999	2000	2004	2015
Gabelli Associates	7.9	16.6	18.1	5.5	9.4
Citi US Broad Investment Grade Bond Index	-2.8	-0.8	11.6	4.5	2.6

Source: Gabelli *1994: six rate rises, 1999: three rate rises, 2000: three rate rises, 2004: five rate rises, 2005: eight rate rises

Dividend

The trust's stated policy is to pay an annual dividend, which will account for 5% of NAV. The strategy seeks to generate income but the dividend may also be funded with capital. Though an increasing number of closed-ended funds are following this trend, we think this is a sensible strategy for GMP and one that is a selling point for the trust. This is because they will be receiving capital returns on a regular basis when deals are completed and, therefore, will be funding the dividend from excess cash rather than from selling existing holdings. An interim dividend of $0.23 was paid in January, representing a yield of 2.2% on the current share price with its Q1 dividend announced on April 3 of $0.12 payable on April 27.

Gearing

As previously mentioned, though Gabelli has managed dedicated merger arbitrage strategies for more than three decades, GMP is the first fund of this ilk to use leverage. According to the prospectus, the trust is authorised to have maximum gearing of up to 2.5x of NAV. However, the board anticipates gearing will not exceed 2x and will come from both structurally gearing and tactical leverage and short-term borrowings.

Management

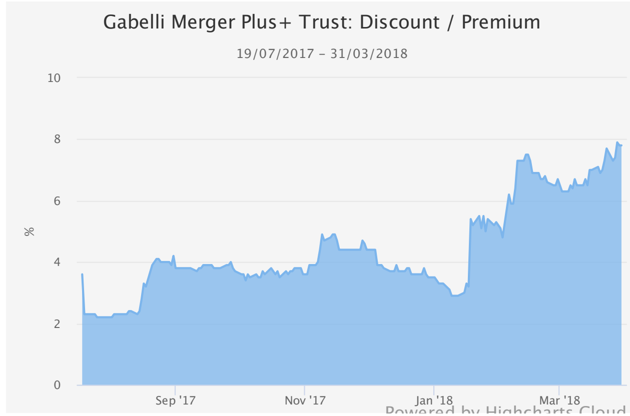
Though not particularly well-known in the UK, Gabelli is in 'household name' territory across the Atlantic and has grown to be one of the leading fund management groups in the US. GMP's management team is led by Mario and Marc Gabelli (who is also Chairman), and are supported by a team of more than 25 portfolio managers and more than 40 research analysts, giving the trust significant firepower in terms of experience.

Gabelli was founded by Mario Gabelli, who pioneered the "PMV with a Catalyst" approach, in 1976 as an institutional research firm. It is now a publicly-listed company in the US that employs over 200 individuals, oversees assets worth c.$45bn and manages around 2,000 separate accounts for institutions and high-net worth individuals. It runs over 30 open-ended funds and 16 closed-ended funds, making it one of the largest closed-ended players in the US, with c.$7.5bn AUM. Outside of the US, it has offices in London, Tokyo and Shanghai.

Discount

Like most other recent IPO's, GMP jumped to an immediate premium at launch and continues to trade at a 5.15% premium to NAV. It will take time to work out what the natural premium/ discount range will be. In a world where investors are crying out for an attractive income, but are looking for greater diversification given the significant rally in both bonds and equities over the past

eight years or so, means GMP, with its low market correlation merger arbitrage approach and 5% annual distribution to shareholders, is a highly appealing offering, in our opinion.



Source: Morningstar

Gabelli Merger Plus+ has an innovative approach to rewarding long term investors. Shareholders who hold the trust for more than five years will receive greater voting power, while investors at IPO were offered a 'five-year put', meaning they have the opportunity to sell their shares back at the then NAV after the first five years. These were introduced to align interest and incentivise long-term ownership. However, if the discount were to widen out, the board has stated its intention to buy back shares at or beyond 7.5%.

The board has also used the premium to grow the trust, raising some $3.4m via a new issue in November. At this point in time, the shareholder register is biased towards overseas investors, but we understand that the board is making a greater push into the UK market over the coming year.

Charges

GMP has a management fee of 0.85% and a performance fee of 20% on absolute performance, which is subject to a hurdle rate and a high water mark.

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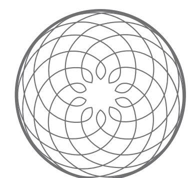

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