By Dan Weiskopf
Access ETF Solutions Portfolios

Interview series: Investment Factors that drive ETF performance

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In this latest piece we met with Salvatore Bruno, the Chief Investment Officer of IndexIQ. Sal is responsible for research and product development at IndexIQ's alternative investment strategies. As the developer of the first US based family of hedge fund replication strategy indices, Sal was early to recognize the benefits of the ETF wrapper and define the IndexIQ investment methodologies by specific factors and rules. His work at IndexIQ has been leading edge in the ETF market given the challenges in defining the factors that affect portfolio performance under various circumstances especially in defining the rules based strategies in the alternative market. Prior to joining IndexIQ, Sal was a Portfolio Manager as well as Head of Advanced Quantitative Research at Deutsche Asset Management.

Dan Weiskopf: According to data from Thomson Reuters analyzed by PricewaterhouseCoopers, the U.S. saw 4,654 M&A deals worth about $875 billion from the start of the year through May 31.[i] What key factors, besides cheap money, are driving M&A activity?

Salvatore J. Bruno: Merger activity over the last 12-18 months has accelerated. While it is difficult to point to any one factor, there are a number of factors that are contributing to the increase. I agree that the combination of cheap money both in the form of borrowing costs to fund cash for leveraged buyout deals and a stock market that has touched record highs has increased M&A activity. Weakness in the economy has also increased activity - companies looking to increase earnings per share through acquisitions seem to be downplaying the impact of weaker organic earnings. In health care, many announcements have been made by cash rich, large pharmaceutical companies looking to bolster their drug pipeline as patents on existing drugs expire. Also, companies that were able to complete their tax inversion prior to the Obama administration's move to deter inversions in late 2014 now have a competitive advantage vs. other companies that were blocked. Companies such as Actavis have been particularly aggressive in the M&A space having already moved their headquarters to Ireland from New Jersey.

Dan Weiskopf: How should investors expect your strategy to adjust to when low cost money and central banks stimulus ends in the US?

Salvatore J. Bruno: The mix of stock and cash in deals has been fairly constant with approximately 60% coming from cash and 40% from stock. As cash becomes more expensive, there is the potential for more stock to be used in deals and/or overall deal activity to slow. However, as an increase in interest rates is likely to lead to a slowing of economic growth with a commensurate effect on corporate earnings, there could be a renewed focus on M&A as a means to grow EPS.

Dan Weiskopf: Your M&A strategy is about 83/17% US/Europe, respectively. What factors might lead to a more global weighting or should investors look at this strategy as a US allocation?

Salvatore J. Bruno: The strategy has historically been more weighted to US deals relative to the rest of the world. However, there are 2 effects at play here and it is important to understand these factors to understand how the allocations are determined. First, we have to look at the number of announced deals. Historically, there have been more deals announced internationally than domestically. This would argue for a larger weight outside the US. However, one also needs to take weighting into consideration. When you look at the size of the deals in dollar terms, historically there has been a greater dollar value of deals in the US than outside the US. Our portfolio allocates weight to the deals based on liquidity (or average dollars traded) of the company. Given the high and positive relationship between market cap (size) and liquidity, it is not surprising that we will have more of the portfolio allocated to US rather than to non-US deals. If we were to see a real acceleration in the number or size of non-US deals, the portfolio would likely have a greater allocation in the developed international markets.

Dan Weiskopf: Might a strong dollar lead to an increase in your weightings abroad as US companies take advantage of a strong currency and high US multiples relative to abroad?

Salvatore J. Bruno: The currency tends to be cyclical and we are currently in a period of dollar strength. In this environment, we might expect to see US companies using the stronger currency to purchase assets that are cheaper due to exchange rate differences (much the same as a US tourist would want to travel abroad and use the stronger US dollar to purchase goods and services). If we see a strong turnaround in the strength of the dollar, it is possible that we would then see foreign companies using their stronger currency to buy US dollar denominated assets.

Dan Weiskopf: What factors are leading to a 51%[ii] position in large cap stocks and the balance in mid and small cap stocks? Is this a sign that the boom in M&A is at the tail end?

Salvatore J. Bruno: A greater allocation to large cap names is not necessarily a requiem on the state of the M&A market. Remember, we use liquidity (or average dollars traded) to determine the weights in the portfolio. Again, as larger cap stocks tend to be more liquid, we would expect to have a greater allocation to large cap stocks, even if more deals are taking place in the mid and small cap part of the market.

Dan Weiskopf: Your strategy is pretty well diversified across sectors at about 27% healthcare, 15% cyclicals, 14% technology and energy, consumer staples and basic materials each representing about 10%.[iii] What factors might lead to the sector allocation changing materially? Are more deals or a higher allocation an indication that there is greater value in a specific sector or is this a reflection of your process?

Salvatore J. Bruno: The sector concentration varies through time and depends on which sectors are seeing the most activity. Currently, health care companies have been very active, particularly pharmaceutical firms. We have also seen an increase in energy related deals as the drop in oil prices has put tremendous pressure on margins and has made some companies more willing to engage in M&A talks. Technology is a sector where we have seen a number of deals, particularly in the semiconductor space as firms scramble to compete with each other.

Dan Weiskopf: M&A is a high turnover strategy. How do you manage the short side of the strategy? Have you seen a higher velocity in your turnover in these past 24 months? How have you protected capital when deals have broken.

Salvatore J. Bruno: We have short exposures to broad markets as well as to sectors to help manage the downside risk associated with the stock portion of the deals. While we have seen some variation in the size of the overall hedge position, it has typically varied between 30% and 40% of the portfolio. When deals get broken, there is obviously the risk that the stock price of the target reverts back to its (lower) pre-announcement price. All merger arbitrage strategies are subject to this risk to some extent. Our process does not require that we remove a stock immediately when a deal breaks. Rather the stock gets removed at the next scheduled rebalance. This has often proved to be helpful as companies may receive an alternative bid following the cancellation of a prior bid. This second bid can help mitigate the losses one would incur by immediately selling the stock once the deal has broken. To the extent we have taken losses on these deals, the losses have been used to offset gains in the funds. Coupled with the in kind creation/redemption process of ETFs, our portfolio has not distributed a capital gain over the last 4 years.

Dan Weiskopf: Sal, thank you again for your time today. Thank you for bringing innovation to the ETF market.

Salvatore J. Bruno: Thank you for the opportunity to discuss this strategy.

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Dan Weiskopf is a portfolio manager of Access ETF Solutions LLC, whose third-party ETF strategies are offered through IPI Wealth Management, Inc. (IPI). IPI is an SEC-registered investment adviser, with its principal office located at 226 W. Eldorado St., Decatur, IL 62522, 217-425-6340. Access ETF Solutions LLC was established in 2013 with a focus that structure matters in selecting ETFs. Access ETF Solutions LLC is not affiliated with IPI.

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[i] http://www.forbes.com/sites/maggiemcgrath/2015/06/17/why-2015-could-be-the-best-year-for-ma-since-the-financial-crisis/?utm_campaign=Forbes&utm_source=TWITTER&utm_medium=social&utm_channel=Investing&linkId=14988089

[ii] http://www.nylinvestments.com/polos/MEMNA05-041553678.pdf and XTF.COM