benefits and Pensions Monitor’s executive editor, Joe Hornyak, recently had an opportunity to talk alternative investments with Sophie Elkrief, head of fundamental alternative strategies and manager of risk arbitrage funds at Dexia Asset Management. Based in Paris, France, she is part of an alternative investment team of 50 portfolio managers and analysts who manage more than $7 billion in assets.

Benefits and Pensions Monitor: Where are the main interests today in alternative investments?

Sophie Elkrief: We believe one of the main areas of interest in alternative investments for 2011 will involve M&A which can be played through equity long/short and event driven strategies; such as Risk Arbitrage.

There are two main reasons for this. The first is that companies have built up large pools of cash. As we all know, cash is yielding close to zero so investors are demanding that this cash be put to work. This leads into the second reason which is the risk mindset of corporate management teams.

Companies are no longer looking to avoid risk at all costs. They are looking at how to create long-term growth. Although there are signs of a recovery, low levels of overall economic growth are predicted to continue in the U.S., Europe and Canada for quite some time leading to fewer opportunities for organic growth within companies. This creates a large incentive for these cash rich companies to pursue external growth through acquisitions. We believe that we have seen the low for M&A activity and, accordingly, the volume of M&A activity will significantly increase in 2011.

Bringing this back to alternative asset management, it means more activity and more opportunities, which in turn means a better risk/return profile for M&A related strategies.

BPM: How much of the investor consideration of putting money into risky assets, particularly when we are talking about pension funds, has to do with the fact that they have to find places to generate alpha and traditional sources of alpha are not there?

Elkrief: It is a driving force, of course. As well, however, properly managed hedge funds are not as risky as many investors perceive. Hedge fund returns were not so terrible in 2008. They were much better than the equity markets and the credit markets. There was a big problem in liquidity, but that was not limited to hedge funds. This leads, however, to one of the main challenges that hedge funds face going forward – they need to re-establish trust. Investors need to believe that liquidity will be there when they need it.

BPM: Were there any particular areas of hedge funds that performed better over the past two years?

Elkrief: In the past two years, the ones that performed the best were those that have benefited from the recovery in the credit markets. You really had very strong performance from the credit markets. Based on this, you had some global macro funds do well. In addition, you had a lot of commodity-based funds do well as commodities were a very hot spot.

BPM: As an investor, what sort of signals were you looking for to indicate that the recovery had started?

Elkrief: As is always the case after a downturn, the credit markets were the first to recover. For a strong rebound, you really need to have stabilized credit.

Once credit markets have been stabilized, you can refinance. You have appetite for credit issuance, and so on. The second stage is to have confidence. Companies feel that their house is back in order and they have gone through the crisis, so they are focused on moving forward.
This leads to interesting opportunities from our perspective because we are an alternative asset manager and we are bullish for mergers and acquisitions. We believe that you are going to see the volume of mergers and acquisitions go up.

**BPM:** And where do you generate your return in M&A?

**Elkrief:** There are different ways to benefit from this activity. The most obvious one is arbitrage. What do you do in risk arbitrage and merger arbitrage in general? You have announced mergers and acquisitions and you take a position based on whether you believe the proposed deal will close.

For example, you have an announced deal in Canada where in 30 days one company is buying another at $17.35. Let’s assume that the stock is currently trading at, say, $17. The job of people who are doing merger arbitrage is to say: “Okay, I think the deal will go through and I am ready to buy at $17 to make 35 cents”. You might think that $0.35 is very little. I would argue that you have a very high probability of making that over a known time period. It means that you have a very strong probability of making your return in, say, a three-month time frame. So you are going to make two per cent over three months ($0.35 on a cost base of $17). On an annualized basis, that is an eight per cent return with very low volatility (about three to four per cent in my experience).

The volatility is controlled because the stock price will tend not to move according to the equity market; rather, it will move according to what is happening concerning the deal. This puts you in a position to offer a very diversified source of return with very low volatility. If you want higher returns and are willing to take on more risk, you can also apply some leverage to the strategy.

It is also important to have a large number of deals. To start, it diversifies the risk in your portfolio and helps you meet your return targets. More deals means less impact on your portfolio if a deal breaks and more deals makes it easier to replace deals that have closed.

So do we have a lot of deals expected in the future? The answer is yes. I could show a chart over the last 50 years and it has the same pattern. It is very cyclical. It lags the recovery in major economic indicators. As the economy starts to recover, mergers and acquisitions volumes start to pick up again.

We strongly believe that this cycle is just starting to pick up and we will see an increase in M&A activity which will last for a couple of years because we are talking about long cycles.

**BPM:** Do you expect that we are going to get back to the levels that we were at back in 2007?

**Elkrief:** In the short term, the good news is that, if we have just passed the inflection point, and we strongly believe that this is the case, you can make money for a while as the cycles are long.

In the long term, I do not know if we will go back to those levels. However, if you remember 1999 with the internet bubble, the level of mergers and acquisitions was the biggest in the history until new records were set in 2007.

**BPM:** But the internet bubble had burst in 1999?

**Elkrief:** That is true, which speaks to the cyclical nature M&A. The value in 2007 was higher than in 1999/2000, yet if you were to go back 10 years ago, everyone was amazed by the amount of mergers and acquisitions then.

This leads me to think that the M&A cycle is growing and that we might even go further than 2007 because all the markets are growing – especially now with Emerging Markets still growing. In some cases, they are no longer emerging, they have emerged.

So yes, I am quite optimistic in terms of the growth.

**BPM:** Do you think interest rates may have some impact on M&A volume?

**Elkrief:** You can look at that two ways.

Now interest rates are so low that you can borrow cheaply and your cost of financing is low. If interest rates go up, then the cost of financing will go up so it is more difficult to finance an acquisition.

However, usually, if we are in the rising interest rate environment in the second year of the cycle, you are not yet fighting inflation. You just want to control growth and inflation.

This is exactly what happened in 2004/2005. It means that you are in a good part of the economic cycle.
You have growth so you are making more money, and more profit so your ability to pay off debt is much better. So you are not so much affected by interest rate increases and what you observe is M&A volume increases in line with interest rate cycle.

Another way to look at it is increasing interest rates normally also means increasing confidence in the future and, as I mentioned before, confidence is very good for M&A activity.

**BPM: What do you find sponsors are currently looking for?**

**Elkrief:** In the meetings we have had with plan sponsors about alternative investments, most of them say they are looking for low beta and returns of LIBOR plus 400 or 500 basis points. In other words, the expected return has gone down, but they want an absolute return and controlled volatility of between four and five per cent.

**BPM: At what point, as an M&A investor, are you deciding to make this investment? Are you making it after they have announced the deal? Are you making it when you are hearing rumblings about the deal?**

**Elkrief:** When we are speaking of M&A, we are talking about decisions made after the deal has been announced.

You can also get a source of alpha out of a strategy called special situations. In that strategy you take a position on something that is not priced into the market.

**BPM: What would a typical special situation be?**

**Elkrief:** It is very flexible. Special situations are event driven strategies, but they are very different from all the big event-driven funds that you might have in the U.S.

It is really focused on what can happen to create a big movement in a share price. So you might anticipate an acquisition or you might say "these people need to merge or they will die over time." If you believe they are going to merge, you analyze the competitive environment and so on and you take a position.

**BPM: So in special situations you are almost playing it as you would any equity. It just becomes a fact during your consideration of purchasing an asset and holding on to it.**

**Elkrief:** Exactly, it is all about strategy, management, and competitive positioning and not just about spreads and probabilities.

One key difference, however, compared to how most people invest in equities is that you want to hedge out the market risk. So in special situations, you could be long a stock and short the sector. In this way, you can reduce the market risk, but be exposed to the stock specific situation.

**BPM: Are there particular sectors that you are interested in now?**

**Elkrief:** We like cash rich sectors because, when you have cash, you have access to credit. Energy will be very active as companies search to replace reserves. Oil services will also be active because, if you want to get good contracts, you need to be big. You need to have a large balance sheet and it's an area where we expect to see a lot of merger activity.

We also like healthcare as they have huge cash reserves and it can be cheaper and quicker to buy R&D than develop it internally so they are going to continue to buy assets.

On the consumer side, you are going to see acquisitions as companies seek to buy growth in emerging markets.

**BPM: So where does it all end up?**

**Elkrief:** The investment industry is diversifying. Mainstream firms were entering or expanding within the hedge fund space because they see opportunities to serve their clients needs and better risk/reward trade-offs.

You have another kind of convergence now as some hedge funds are doing private equity and some private equity houses are doing hedge funds. So you have a change in the landscape of asset management. It is becoming much less divided. It is evolving.