

WESCAP MANAGEMENT GROUP

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1997--Winter Quarter

Items of Interest to WESCAP Clients and Other Readers

The Urge to Merge

Recent stock market declines and generally high U.S. stock valuations may have you asking "what else can I do with my investments?". Short-term bonds are relatively safe, but they cannot deliver the long-term returns to make them a long-term portfolio mainstay.

One viable alternative is to use various hedging techniques to reduce downside risk and to still deliver equity-like long-term returns.

Various private hedge funds have used these techniques for years. Hedge funds though are not generally available for most investors and information is scarce. However, the **Merger Fund**, an open-end, no-load mutual fund, uses a sophisticated hedging technique: **merger arbitrage**.

The 5-year trailing annual return (through September 1997) for the Merger Fund is 11.3%. This is close to the 60+ year long-term return of the stock market. The risk by any measure has been quite low. For example, in 1994, a year when most stock and bond mutual funds lost money, it made 7.1%. According to a recent study by Micropal, Inc. (6/16/97 Investment News), the **Merger Fund had the best return "per unit of risk" of any equity mutual fund.**

The following example will show how merger arbitrage works. Let's say that Company A decides to buy Firm Z by offering one share of its stock for each share of Firm Z's stock. Prior to the buy-out offer, Company A's stock is at \$50/share and Firm Z is at \$30/share. Immediately after the announcement of the buy-out, Firm Z's stock goes up \$15 to \$45 per share.

However, the stock does not go up to the full \$50 per share as announced in the buy-out offer. This is due to a number of factors including anti-trust considerations and the time expected to complete the buy-out.

Assuming the deal looks viable and is not expected to take too long to complete, the Merger Fund could do the following: *Buy* shares of firm Z at \$45 each and simultaneously *borrow* shares of Company A from a lender and then *sell* them at \$50 per share (i.e., selling short). At this point, the Merger Fund has locked-in a \$5 per share profit, when the buy-out is completed. It no longer really matters what the stock market does in the meantime.

To illustrate this, assume the stock market goes down 20% and Company A stock goes down to \$40 per share. Thus, at the buy-out, the Merger Fund now gets \$40 for each share of company Z. The fund bought it for \$45, so there is a \$5 loss. Recall that the fund also borrowed and sold short at inception one share of Company A for \$50. After the market decline, the fund can buy it back for \$40 per share, which it does and then returns the borrowed share to the owner. The Merger Fund makes \$10 on this transaction, which when combined with the \$5 loss earlier on Firm Z results in a **\$5 net profit** per share despite a major market decline.

The key in this strategy is to have the buy-out or merger go to a timely completion without being derailed by anti-trust or other issues. Unlike the 1980's, today few mergers and buy-outs are hostile takeovers or done on a highly leveraged basis (LBO's). Instead most are done for strategic reasons that both companies favor. Thus the chance of deals falling apart due to stock market or financial changes is now much

lower than in the past. The Merger Fund focuses on *announced* deals rather than on merger or buy-out *speculations*.

Merger arbitrage also requires that transaction and stock borrowing costs be kept low and that the arbitrage price spread be sufficiently attractive. Set-aside required collateral (usually T-bills), needs to be low since these assets generally earn less than the merger and buy-out transactions. We learned during one of our routine calls to the Merger Fund that in early 1997 the amount of required T-bill collateral was lowered for the fund, thus allowing for a higher potential rate of return on assets. This, combined with the continuing record volume of mergers and buy-outs of the last few years (with no end in sight), allows for plenty of opportunity to do well with merger arbitrage.

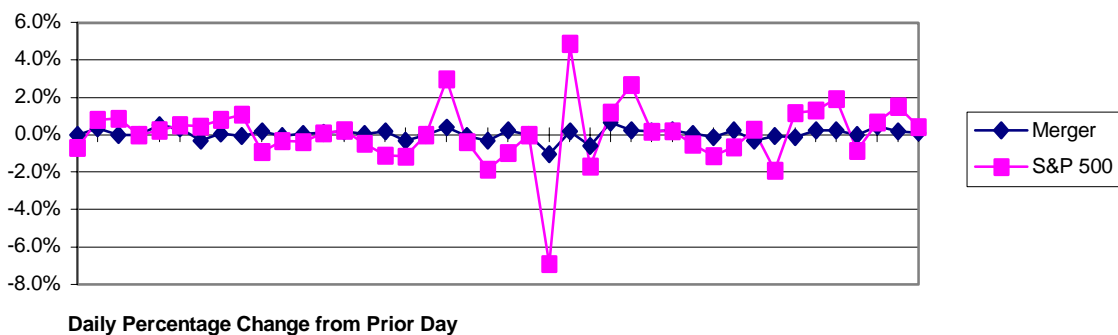
According to the most recent (10/24/97) Morningstar report, the correlation (R-squared) between the Merger Fund and the S&P 500 index was only 0.07. This means that only about 7% of the Merger Fund's performance could be "explained" by what happened in the stock market. Neither interest rates nor other general market or economic indicators have a high correlation to this fund.

Morningstar also reports the Merger Fund's standard deviation as only 2.94%. This indicates very little fluctuation in value, which is illustrated in the graph below. This graph shows daily percentage price changes of both the Merger Fund and Vanguard S&P 500 Index fund over the volatile sixty days ending on November 21, 1997.

Not only was the Merger Fund much less volatile (**a 1% maximum daily loss versus a nearly 7% one-day loss for S&P 500**), but it had a higher return over this time period (2.5% return versus 2.2% for the S&P 500 fund).

The high turnover of this strategy generates significant short-term capital gains. This is not good for some investors, but is fine for IRAs, more cash-flow oriented investors, or those who might otherwise invest in bonds or anyone just concerned about stock market risk.

The Merger Fund is closed to new investors, except through some investment advisors, including WESCAP. The fund is now large enough to lower its annual expense ratio, but the fund's closing should keep it from getting too big and hurting performance.



If you have questions about the above, please contact Mark Gleason, Rick Weinlein or Joel Edstrom at (818) 552-2130 or fax to (818) 552-2133. WESCAP Management Group has obtained information from sources believed to be reliable, but no guarantee can be made as to its accuracy. WESCAP Management Group provides high quality, personalized, objective financial and investment advice to individuals.